No. 676. 278. 39. Con[illegible]
Brief of Crawford & Smith for App.
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Filed Dec. 21, 1896.

Supreme Court of the United States.

Office Supreme Court, U.S.
FILED
DEC 21 1896
JAMES H. McKENNEY,
Clerk.

OCTOBER TERM, 1896.

SOUTHERN RAILWAY COMPANY,
Appellant,

vs.

CARNEGIE STEEL COMPANY (LIMITED),
Appellee.

Brief in Support of Appellant's Petition for Certiorari.

HENRY CRAWFORD,
WILLIS B. SMITH,
Solicitors.

C. G. Burgoyne, Walker and Centre Streets, New York.—1896.

In the Supreme Court of the United States.

OCTOBER TERM, 1896.

SOUTHERN RAILWAY COMPANY,
APPELLANT,

VS.

CARNEGIE STEEL COMPANY (LIMITED),
APPELLEE.

Brief in Support of Appellant's Petition for Certiorari.

The several propositions of law involved in the decision of the Circuit Court of Appeals, as shown by the record and summarized in the petition, are sufficient to entitle the appellant to the writ.

Questions of gravity and importance are involved, and the application on its face demonstrates that the reviewing power of this Court is necessary to maintain the supremacy of its own rulings and a uniformity of decision in the several Circuit Courts.

Law Ow Bew vs. U. S., 144 U. S., 58.

The decree is not only for a large sum, but relief is awarded upon grounds which will furnish a precedent

for the impairment of every railway mortgage in the country when enforcement thereof is sought.

Probably no ruling has been so frequently misapplied as that of Fosdick vs. Schall. When the decrees of the Circuit Courts were the subject of direct appeals here, this Court emphasized the sacredness of this species of contract lien, because "there seems to be " growing an idea that the Chancellor in the exercise of " his equitable powers has unlimited discretion in this " matter of the displacement of vested liens."

Kneeland vs. Am. Loan Co., 136 U. S., 96.

That opinion declares the settled law in respect to this class of securities to be that "it is the exception " and not the rule that such priority of liens can be " displaced." It is, however, a matter of common knowledge that in actual practice the Circuit Courts, administering and foreclosing railway property, do not confine their bounty to "the few unsecured claims " which, by the rulings of this Court, have been de- " clared to have an equitable priority," but upon all kinds of theories use such a free hand in the payment of floating debt out of the sale proceeds of mortgaged railways that it is a rare exception when "the sacred- " ness of contract obligations" is not destroyed.

Judicial respect for "the vested and contracted priority" of a railway mortgagee evaporates on the assertion of the vague generality of dealing with "a going concern."

Bondholders, out of the *corpus* of their security, are forced to restore a supposed diversion occurring during a receivership not obtained by them and from which they received no interest.

Since the direct supervision over the Circuit Courts has been vested elsewhere than here the tendency to disregard the fundamental principles announced by this Court has much increased.

In many instances the bond creditors deem it less expensive and injurious to submit to the exactions than to continue their resistance.

Such rulings thereby become dangerous and confusing precedents.

In a somewhat similar controversy this Court has, on petition, ordered up for review a decree of the Circuit Court of Appeals for the Fifth Circuit, whereby it displaced the mortgage lien in favor of a supply creditor.

The case is Virg. & Ala. Coal Co. vs. Cent. R. R. Co. of Ga., No. 404 on the docket for the present Term.

The allowance of the *certiorari* in that case fully establishes that the impairment of the bondholders' recorded lien involved questions of such gravity and importance as should fitly be brought here for attentive examination.

To entitle it to the writ now sought, the burden is upon the petitioner to establish a *prima facie* case that the Circuit Court of Appeals decreed erroneously.

Besides the general common ground which was held sufficient to warrant the review of the decree in No. 404, the present application involves certain special considerations which justify the writ.

The attention of the Court will be briefly directed to the several specifications of error which are set out in the petition.

FIRST. It having been adjudged that the rail creditor had an express statutory lien under the laws of Virginia upon the railroad and earnings, the Court had no power to enforce a discretionary equitable charge which was inconsistent with the lien fixed by legislation.

In this respect the decree violates fundamental principles of law and has no precedent to support it.

Fosdick vs. Schall and kindred cases laid down certain rules for the regulation of judicial discretion in the absence of positive legislation creating and restricting liens upon railway property.

The State of Virginia unquestionably had plenary power to enact statutes declaring what claims should constitute liens upon railways and their earnings, and what priority should be awarded them as against subsisting mortgages.

Appellee sued to enforce a lien under the statute. When it was decreed to him the Court was without rightful power to invent a discretionary lien for the same debt upon the same property, of a character materially variant from the valid statute creating and restricting the right.

The function of an equity court in the enforcement of a right exclusively of statutory origin arises out of and is restricted to the specific legislation.

" Whenever the rights of parties are clearly defined
" and established by law, equity has no power to change
" or unsettle those rights or that situation, but in all
" such instances the maxim '*Equitas sequitur legem*' is
" strictly applicable."

Magniac vs. Thomson, 15 How., 281.
Hodges vs. Dixon Co., 150 U. S., 182.

"Where a particular remedy is given by law, and "that remedy is bounded and circumscribed by par- "ticular rules, it would be very improper for this Court "to take it up where the law leaves it and extend it "further than the law allows."

Thompson vs. Allen Co., 115 U. S., 555.

Whenever a State in the exercise of its undoubted sovereignty over property and highways within its own territory has enacted statutory regulations covering the whole subject matter of liens on railroads and their earnings and the manner in which they must be created and enforced, and the priority of such claims in respect of mortgage or other liens thereafter accrued, there is no occasion for any exercise of judicial discretion over the same subject.

Whatever the State law makes liens on property and earnings are such, and must be paid in their statutory rank if perfected and asserted in compliance with the statutory conditions. Whatever claim is not within the statutory description, or is not made effective by the statutory methods, is not a recognizable or enforceable lien, and no Court, State or Federal, possesses any jurisdiction, on some supposed principle of general equity to ignore and repeal a valid State law whereby the property rights of creditors have been thus absolutely determined.

If the State law fixes liens and priorities on railroads and their income, there can be no others born of mere judicial discretion.

The expression of one is the exclusion of all others. The sole judicial function is to administer the State law on the subject of railroad liens and priorities as it exists on the statute book, and proceed no further.

There can be no other lien, either in addition to the statute or as a substitute for it.

Trust Co. vs. K. C., &c., Ry., 53 Fed., 191.
F. L. & T. Co. vs. Candler, 18 S. E., 540.

TWO. As the decree adjudged that $1,621,000 of the consolidated bonds had an express statutory lien prior to the claim of appellee, the Court had no rightful power to deprive them of that adjudged priority by ordering the payment of the rail claim in full out of a fund insufficient to pay such bonds.

Having actually decreed such bond priority in obedience to an express law establishing a rule of property, all judicial action in disregard thereof was prohibited.

Brine vs. Ins. Co., 96 U. S., 635.

By one part of the affirmed decree the intervenor was adjudged to be entitled only to come upon the surplus of the net sale proceeds after full satisfaction of the prior $1,621,000 bonds and interest.

The record shows there was no surplus.

The sale was for $2,020,000, including the Washington property, leaseholds in roads outside the State, $1,351,000 debenture bonds and $2,844,000 first mortgage bonds on other railroads.

The Code did not give, and the Court did not award, the least semblance of lien to appellee upon any of these outside properties and securities. They were undoubtedly valuable, and contributed largely to the fund in court.

Even without asserting recoupment on that account, the entire net fund is still insufficient to discharge the principal and accrued interest of the $1,621,000 bonds adjudged to be first entitled to payment.

After deducting from the gross bid $75,000 paid the Masters for costs and expenses, and $455,144.50 paid in to discharge the deficit of Receivers' operating debts—making a total credit of $530,144.50—there would remain to be distributed under the decree on mortgage and other liens only a net surplus of $1,499,855.50, covering the railroad and all other property. The amount due for principal and interest of the admittedly preferred $1,621,000 consolidated bonds was at time of decree $1,800,000.

This, also, leaves out of the reckoning any credit for the $1,000,000 Receivers' certificates which were by decree constituted a paramount lien upon the railroad prior to all bonds. On the accounting between the preferred bonds adjudged to hold a superior rank and the statutory rail lien, the former were under no obligation to pay off the certificates at their cost, and thereby relieve the appellee as a gratuity.

It is clear upon every test afforded by the undisputed figures that, upon the theory of statutory lien, the fund on which the rail creditor was decreed a postponed lien was inadequate to pay the adjudged first rank bond claim.

Under such circumstances the peremptory order to pay the second charge was an unjustifiable abrogation of the very priority which had been finally decreed as a statutory right to a moiety of the bonds.

THIRD. The decree sought to be reviewed violated the express rulings of this Court and failed to enforce the fixed rule of decision, in that it decreed that the appellee's claim was a "supply debt," entitled to be first paid out of the current income of the receivership.

One of the theories upon which the decree ordered payment was that the claim of the appellee was within the protection of the rule announced in Fosdick vs. Schall.

Without exception the claims which have allowed such preference have been for small sums of strictly operating supplies consumed in the use and purchased on ordinary credit and relying upon current income for payment.

Every ruling of this Court has repudiated the theory of unlimited discretion and severely restricted the allowed preference to a class covering a few exceptional and small claims accruing a brief period before the receivership obtained by the foreclosing bondholders.

The Courts speak of the beneficiaries of this bounty of the Chancellor as "a favored class," such as "ma-"terialmen and laborers and some few others of "nature."

Morgan vs. Texas Cent. R., 137 U. S., 171.

Mr. Justice HARLAN designated the claims fairly within the scope of such protection as "the current "debts, the daily and monthly expenses" which rely for payment on the daily and monthly earnings.

Thomas vs. P. & R. I. R. R., 36 Fed., 808.

In Nat. Bk. of Aug. vs. C. K. & W., 63 Fed., 25, it was decided that the president of a railroad company "cannot be included among that class of employees "who have no means of ascertaining whether a short "credit to the company is safe or not."

The test applied in Kneeland vs. Am. L. & T. Co., 136 U. S., 89, to a claim of car rental for preference as a current operating expense, is conclusive :

"No one is bound to sell to a railroad company or "to work for it, and whoever has dealings with a "company whose property is mortgaged must be "assumed to have dealt with it on the faith of its "personal reponsibility and not in expectation of "subsequently displacing the priority of the mort-"gage liens."

The appellee was not bound to sell rails on long optional credit if remuneration seemed uncertain. It had adequate opportunity of ascertaining whether it was safe in waiving any claim upon "the current income."

In Huidekoper vs. Loco. Works, 99 U. S., 258, it was decided that the vendor of a locomotive "occupied the "position of a general creditor with no special equities "in its favor."

The principle upon which these large transactions on long agreed credits must be refused preference was applied in Thomas vs. Car Co., 149 U. S., 95 :

"The case of a corporation for the manufacture and "sale of cars, dealing with a railroad company, whose "road is subject to a mortgage securing outstanding "bonds, is very different from that of workmen and "employees or of those who furnish from day to day "supplies necessary for the maintenance of the rail-"road. Such a company must be regarded as con-"tracting upon the responsibility of the railroad com-

"pany and not in reliance upon the interposition of a "court of equity."

In affirming the decree the Circuit Court of Appeals not only refused to give effect to this controling decision, but it *sub silentio* abrogated its own recent ruling in Bound vs. S. C. Ry., 58 Fed., 473, delivered when the Chief-Justice constituted a member of the Court.

There as here a manufacturer sold rails to a railroad, and, after an agreed credit of about eight months and ten months' later extension, claimed a preferential allowance against the *corpus* on the ground that its debt was an "operating expense" and there had been a diversion to pay bond interest, &c.

It was decided that it had waived all claim upon current earnings by the credit given and renewed, which was in law a consent to use the current earnings for bond interest and otherwise.

It declared that this Court had indicated the narrow limits to which an equity court should confine itself in allowing any unsecured claim to displace vested contract liens.

The conclusion reached was:

"The debt of the Lackawana Company was an ordinary merchandise debt, evidenced by notes which "were renewed from time to time. It had no stronger "equity or claim upon the earnings than had those "who had advanced money to pay the interest upon "the bonds.

"The claim is quite different from those ordinary "and necessary current expenses of operating the railroad contracted but a short time before the receivership, and which, by the sudden action of the Court, "are left unpaid."

The claim originated too long prior to the receivership to be within any accepted test of preferential recognition.

The order in the first receivership case recognized all claims accrued within the preceding six months as proper to be paid.

The appellee was a party. Neither it or any other creditor ever asked the Court to enlarge the terms of the order.

In fact, it never even made any claim of preference until long after the first Receivers had expended all their earnings and been discharged and the foreclosure suit had been instituted.

The principle is "to prevent the indefinite extension "of such claims the Courts limit the time within "which such demands may be pursued."

The claims recognized by the Court as entitled to protection must be those of the restricted class "ac-"cruing for a brief period prior to its intervention."

In the Fourth Circuit the common practice in railway receiverships seems to fix 90 days as the extreme limit within which operating claims must have been incurred to be allowed as preferential.

Fire Co. vs. C. C. & C. R., 62 Fed., 205.
Ibid. vs. Ibid., 52 *Ibid.*. 526.
U. S. Trust Co. vs. N. Y. & W. S., 25 *Ibid.*, 800.
Miltenberger vs. R. R., 106 U. S., 286.

Four months was fixed in

Wood vs. N. Y. & N. E. R., 70 Fed., 741.

In the following cases it was declared that the extreme limit of a "reasonable time" was six months :

Tumer vs. I. B. & W. Ry., 8 Bissell, 315.

Blair vs. St. L. R. R., 22 Fed., 471.
Swayne vs. W., St. & P., 46 *Ibid.*, 38.
Thomas vs. P. & R. I. Ry., 36 *Ibid.*, 808.
Putnam vs. J. L. & St. L. R., 61 *Ibid.*, 440.
Stat. Bk. of Aug. vs. C. K. & W. Ry., 63 *Ibid.*, 25.
Union Trust Co. vs. Souther, 107 U. S., 592.
Ibid. vs. Midland Ry., 117 *Ibid.*, 463.

Mr. Justice HARLAN characterized that limitation "as "wise and salutary."

"When, therefore, debts of that character remain "unsettled, or are not put in suit for such a length of "time as would be deemed unreasonable, it may be "fairly presumed that the creditors have ceased to look "for current receipts for payment, and have accepted "the position of general creditors, who as such need "have no claims for indemnity upon any special part "of the income."

Thomas vs. P. & R. I. Ry., 36 Fed., 808.

Mr. Justice BREWER, on the Circuit, said in Blair vs Ry. Co., 22 Fed. Rep., 474:

"Six months is the longest time I have noticed as "given.

"If any person permits a claim to continue longer "than that, he certainly has no right to be considered "other than as a general creditor with no preference "over a secured debt."

By agreed credit and extensions the appellee sold rails relying on the mere personal responsibility of the railroad company from July, 1891, to October, 1892.

It thereby absolutely released any claim for payment out of the current earnings of the system during that period, and left the railroad company a free hand to

dispose of its income at will without any liability to ever account to it therefor.

This rail creditor has forever precluded itself from claiming that a dollar of the earnings prior to October, 1892, should have been used for the payment of its claim. That was not due and it had expressly agreed that it need not be paid out of these current earnings.

It was bound to take notice that during that period three interest payments would mature upon the consolidated mortgage, October, 1891, and April and October, 1892, and current rentals on leaseholds and equipment would have to be met.

In respect to its assertion of an equity against the foreclosing bondholders, it was not a supply creditor with a preference either upon the income or *corpus*, but a mere general creditor who sold rails on the mortgagor's personal responsibility nearly two years before the foreclosure suit was brought.

FOURTH. In charging upon the bondholders security, expenditures of a prior receivership obtained by general creditors when the mortgage was not in default and did not apply, the decree was contrary to equity and denied effect to the express rulings of this Court.

Although the original Receivers only made such payments out of their earnings as they were specifically required to make by orders which remained unchallenged by the appellee and all other creditors until after foreclosure, the opinions hold that "the Receivers diverted the earnings and funds in their hands," to better-

ments, additions and payment of interest and the appellee as a neglected creditor, from whom the earnings were thus diverted, has the right to ask that the Court shall recognize and preserve their debts out of the *corpus* of the bondholders subsequently applying to foreclose.

All the statements of earnings and disbursements made by the Judges are framed upon the theory that the consolidated bondholders must make good out of their estate the wrongful appropriation of earnings made by the Court itself during the original receivership.

As the default on the consolidated bonds did not occur until October, 1892, and they did not apply to foreclose until July, 1893, they had no possible claim to any earnings prior to their suit, and they received no interest.

There is no tolerable legal principle on which lien creditors having a specific contract lien of certain rank can be partially deprived of property right because of a judicial administration of the property affected, at the suit of other creditors and when they were not possibly entitled to any surplus, if realized.

The precise question is set at rest by this Court in Kneeland vs. Am. L. & T. Co., 136 U. S., 89, where this Court reversed a decree charging the bondholders security with the expenses of a general creditors' receivership.

" The receivership was at the instance of a judgment
" creditor, and was with a view of reaching the surplus
" earnings for the satisfaction of his debt. It was not
" at the instance of mortgagees, nor were they seeking
" foreclosure of their mortgages. They were asking
" nothing at the hands of the Court. They were not

"asking it to take charge of the property, or thus im-
"pliedly consenting to its management of the property
"for their benefit.

"Neither lienholder asking the aid of the Court, no
"obligation was assumed by either in respect to the
"management of the property as against the
"other."

The same doctrine that there is no equitable accountability of non-applying mortgagees to restore income paid out under Court orders during a prior receivership has been applied in other cases.

Morgan vs. H. & T. C. Ry., 137 U. S., 171.
Swayne vs. W.. St. L. & P. Ry., 46 Fed., 38.
Street vs. Mary. Cent. Ry., 59 *Ibid.*, 25.

"But the intervenor has no equity as against the
"first mortgage and other liens superior to the second
"mortgage. These classes of creditors did not of their
"own volition come into equity, and the rule cannot be
"applied to them to do equity. They can stand upon
"their legal vested lien."

Bound vs. S. C. Ry., 47 Fed., 33.

The bondholders had the clear equity to have the decision of this Court enforced for their benefit and to be protected against the spoliation of their fixed security by an alleged equity arising out of the disbursement of earnings upon which they had no claim.

FIFTH. The decision that the consolidated mortgage must restore the moneys paid for interest and rentals upon cars and leased lines, during the first receivership, is contrary to express rulings of this Court.

Neither the foreclosing consolidated bondholders or the prior debenture bondholders received any interest on their liens during either receivership. The only mortgage interest paid during those periods was on the Richmond and Danville firsts, the car trusts and the first mortgages on the leased lines.

The decree makes the foreclosing bondholders chargeable with the interest paid during the receivership to mortgage bondholders other than themselves, and the fund in court is adjudged to make good such payments to others.

This Court disposed of that precise contention in St. Louis R. R. vs. Cleveland R. R., 125 U. S., 668:

"It cannot be said that the application of earnings "to payment of interest on the first mortgage bonds is "chargeable to the holders of the second and third "mortgage bonds. The latter alone are interested in "the fund for distribution. That fund, in the sense of "the rule sought to be applied, cannot be said to have "been benefited by the payment to the other bond-"holders from the gross earnings applicable to the "payment of rent. The equity of the petitioners, if in "fact it exists, is against the holders of the first mort-"gage bonds, who have actually received the money "to which it claims to be equitably entitled."

It was in addition insisted that the interest, rentals and dividends paid on the leased lines during such receivership was a diversion for the benefit of the foreclosing bondholders, and the sale proceeds are chargeable with restoration of such sum.

It has already been shown that the user of the leased lines was not at the instance of the consolidated mortgage bondholders, and their security cannot be charged with any deficit resulting from compliance with the

Court's orders in a suit not brought by them, and when their debt was not in default.

These rental payments for equipping and feeding leased lines were all made under orders of the Court, not applied for by the bondholders.

They submitted to have $1,000,000 of Receiver's certificates placed in front of their bonds for the purpose of enabling the current income to be thus used to realize earnings upon which they had no possible claim.

The appellee made no attempt to modify them or intercept the expenditures on that account, and must therefore be conclusively presumed to have accepted and approved them as being for the best interests of the whole trust estate including its own.

> Cent. Trust Co. vs. Wabash R. R., 34 Fed., 259.
> Miltenberger vs. Log. R. R., 30 *Ibid.*, 332.
> Calhoun vs. St. L. R. R., 14 *Ibid.*, 9.
> Kneeland vs. Am. L. & T. Co., 136 U. S., 89.

Especially is this to be the case when the intervenor, in order to establish a claim for diversion, claims the benefit of the valuable leases and the gross earnings of the entire system.

The income and beneficial traffic of the controlled lines cannot be availed of without accepting the burden of their fair rentals as a necessary operating expense of current management. It is not a diversion to be made good out of the specific security of mortgagees who did not apply for the order and whose own current income was depleted several hundred thousand dollars to pay the arrearages of the Receivers.

SIXTH. The affirmed decree erroneously severed the single lien of a railway mortgage and separated the bond issue into preferred and deferred obligations.

Such a mortgage takes rank as of its record.

This principle of absolute equality of all the bonds issued under the trust deed is of the very essence of such a security and cannot be broken in upon by any judicial construction, subsequent contracts, acts of the parties or legislation.

> Pennock vs. Coe, 23 How., 117.
> Jackson vs. Ludeling, 21 Wall., 616.
> Stanton vs. A. & C. R. R., 2 Woods, 523.
> Ames vs. Railroad, *Ibid.*, 206.
> State vs. Cobb, 64 Ala., 127.
> Barry vs. M., K. & T. R. R., 34 Fed., 829.

Such a basis of credit would be absolutely valueless if it was not held to be what it recites, a common security for the ratable benefit of a class of beneficiaries equally entitled to share therein.

The consolidated mortgage in the first article declares " this mortgage shall be a security for the whole " or any part of the amount of the bonds authorized " to be issued as herein aforesaid, and all bonds issued " hereunder, shall be equally secured hereby without " regard to the time when the same may be issued " (Record, 63).

In a recent Pennsylvania case, the non-severable nature of such security a was rigidly enforced.

" The bonded debt is a unit, so far as the duties and " powers of trustees are concerned. He must regard " the bondholders as a class, and not as individuals.

" It has been held to be a presumption of law that

"all the bonds were issued at the same time which "were secured by the same mortgage, and that the "fact that they were numbered consecutively gave no "priority to any and interfered in no manner with the "equality of their holders on distribution. That "distribution must be made *pro rata* is well settled.

"What may be realized by such proceeding belongs "to the whole class and must be distributed *pro rata*."

Com. vs. S. & D. R. R., 122 Penn. S., 306.

SEVENTH. The claim of diversion based upon the purchase of steel rails by the Receivers from the appellee gives the latter no equity to charge the mortgage security with a restitution of what was wrongly received by the appellee.

The alleged diversion by reason of interest paid to senior mortgagees and of car trusts and rentals has been already discussed.

Special stress is also laid upon the income diverted to payment of permanent improvements. The Receiver's reports when analyzed show that very much the larger part of this class of expenditures consists of steel-rail purchases.

The Court thus commits itself to the inconsistent theory that steel rails purchased prior to the receivership constitute a current operating expense, while the same rails bought during the Court's possession is not an operating expense at all, but a permanent improvement of such a character as to constitute an inequitable diversion of the earnings.

No precedent sanctions such a view.

It also appears by the record, page 245, that the rails referred to as diversion were purchased directly from appellee.

It is a most remarkable principle of law that the wrongful receipt by it of income that should have been paid otherwise created an equity in its favor to compel the bondholders to pay over a like amount upon a prior unsecured debt held by it.

EIGHTH. The allowance of $29,828.58 interest by the affirmance decree was in violation of the express ruling of this Court.

This allowance of a large sum for mere interest as such, on a claim against a fund in insolvency refuses obedience to the decision of this Court on the very point in Thomas vs. Car Co., 149 U. S., 116, wherein it was held that no such interest could be recovered.

In the case of N. Eng. Co. vs. Carnegie Steel Co., 75 Fed., 54, cited in both the affirming opinions as authority, such an interest allowance was reversed.

NINTH. There was in fact no diversion of the receivership income, and therefore no restitution can be exacted out of the mortgagee's security.

To establish the charge of income diversion the only figures given in the opinions are that the Clyde Receivers collected $1,151,791.31, which sum "very

nearly paid all the current operating debts contracted within the six months.

The learned Judges of the Court of Appeals have utterly misconceived the figures.

Dunham, the Receiver's comptroller, gave the only evidence on the subject.

It will be found in the record (pp. 403, 404).

He testified that the Receivers actually paid out in cash on ante-receivership debts for traffic balances, pay-rolls and supply vouchers $1,237,196.22, *and that such payments were in addition to the proceeds of sale of the $1,000,000 Receiver's certificates used for the same purpose.*

So that the opinions evolve the theory of diversion by an unintentional underestimate of the six months' supply and preferential claims of $1,000,000.

It is also stated as an important consideration in determining the equitable obligation of the mortgage security to restore that the Clyde Receivers turned over to the mortgagees' Receiver the sum of $141,325.19 and much material.

This method of stating the situation very unfairly ignores the other side of the account, which fully appears in the record.

The new Receivers took the cash and assets of the original appointees and assumed all their obligations.

Dunham's evidence shows the mortgagee's Receivers realized not only the cash stated in the opinions, but also collected other large sums from the earnings of the Clyde Receivers, so that the total realized by them from that source was $535,167.95 (Record, 426).

Those collections and the income of the mortgagee's receivership were used by the foreclosure Receivers to

pay the following expenses and debts of the first Receivers (Record, 427):

Traffic balances	$53,257 20
Damage claims	4,163 45
Pay rolls	467,562 79
Material	515,877 87
Making a total of	$1,040,861 31

The bondholders' administration, instead of receiving any net cash from the first Receivers, as the opinions assumed, actually experienced the burden of a deficit on that account of $505,693.36 over and above all receipts from that source.

The expenditures for construction and new equipment during the receivership were inconsequential.

The situation can be fairly stated as follows: The foreclosing bondholders were paid nothing during either receivership.

The first Receivers paid out of their current income upon the company's labor and supply debts $97,190.64 more than they received from ante-receivership earnings.

The mortgagee Receivers paid out of their current income $505,693.36 on account of the debts of the first receivership over and above all receipts from the latter's earnings.

The bondholder purchasers, in order to protect their security, paid into court $455,144.50 to liquidate the deficit of the last Receivers' operating debts after application of all their earnings, this deficit resulting from the payment of the Clyde receivership debts.

In addition, they paid $1,000,000 Receivers' certificates and interest issued as paramount lien, the proceeds of

which were used exclusively for payment of preferential labor and supply debts accruing in the six months prior to June, 1892. Upon such a showing, the bond creditors' security cannot be further oppressed by any additional assessment to pay a general creditor's debt. Restoration can only be ordered to equalize the sum diverted. Anything is addition is an illegal exaction.

The accounts afford no basis for asserting any right of preference for this rail debt over the vested lien of the mortgagees as already reduced by $1,500,000 on account of supply claims, traffic balances and pay-rolls. Neither they nor their security have ever inequitably received any income to which they were not entitled and the appellee was.

The decree should be brought here for review.

Henry Crawford,
Willis B. Smith,
Solicitors.

December 12, 1896.

No. ~~39~~ 8.

Brief of Phelps for Appt.

Filed Oct. 5, 1898.

Supreme Court of the United States,

OCTOBER TERM, 1898.

No. 39.

THE SOUTHERN RAILWAY COMPANY,

Appellant,

vs.

THE CARNEGIE STEEL COMPANY.

ADDITIONAL BRIEF FOR APPELLANT.
MR. PHELPS' POINTS.

HENRY CRAWFORD,
E. J. PHELPS,
For Appellant.

The Evening Post Job Printing House, New York.

Supreme Court of the United States,

OCTOBER TERM, 1898.

No. 39.

THE SOUTHERN RAILWAY COMPANY, Appellant, v. THE CARNEGIE STEEL COMPANY.	

APPELLANT'S ADDITIONAL BRIEF.

Statement.

The facts in this case are set forth in detail in the principal brief in behalf of the appellant. Their substantial results are these: In June, 1893, the Central Trust Company of New York, as trustee, brought suit in the United States Circuit Court of Virginia to foreclose the consolidated mortgage of the Richmond and Danville Railroad Company, dated October 22, 1886, and under which default had occurred on the 1st of October, 1892. And on motion of the complainant, receivers of the mortgaged property were appointed on the 17th of July, 1893 (*Rec.*, *p.* 233; *p.* 240).

On the 13th April, 1894, a decree of foreclosure and sale was made in that suit, and on the 15th of June, 1894, the mortgaged property was sold under it to parties representing the mortgagees, for the net sum (after deducting costs and expenses of sale) of $1,955,000, the amount found due under the mortgage by the decree being $5,002,155.81 (*Rec.*, *pp.* 262-275-291). The purchasers were subsequently incorporated as the Southern Railroad Company, which is the appellant here.

In June, 1892, and before the default under the mortgage, a suit had been commenced iu the same court by W. P. Clyde and others, general creditors of the railroad company, praying for general relief as such and for the appointment of receivers. And in that suit receivers were appointed on the 15th June, 1892, and authorized to issue receivers' certificates for $1,000,000, which were issued accordingly (*Rec.*, *pp.* 19-134).

That receivership was terminated and the receivers discharged before the appointment of the receivers in the foreclosure suit. And two of the former receivers were appointed (with a third associate) in the latter cause (*Rec.*, *p.* 223).

The complainants in the foreclosure suit were not parties to the suit of Clyde & Co. (though they subsequently became parties), and had no concern in it and no interest in the relief sought. They received nothing from either receivership toward the interest or principal of the mortgage, but were compelled to pay the receiver's certificates issued by the Clyde Receivers, and also a large sum for debts and liabilities incurred by those receivers (*Rec.*, *pp.* 280, 403-29).

The appellee's claim here in controversy is for 4,203 tons of railroad iron delivered to the Richmond and Danville Railroad Company between July and October, 1891, while the road was in its hands, more than a year before the default under the mortgage, nearly two years before the appointment of the receivers in the foreclosure suit, and nearly one

year before the receivership in the Clyde suit (*Rec.*, *p.* 374). The iron was sold under a written contract with the company, on ten months' credit (*Rec.*, *p.* 370). The notes given for it were several times renewed; the last ones, now outstanding, bearing dates from March 21 to June 27, 1892.

A claim founded upon them was filed during the Clyde receivership in October, 1892. In February, 1874, it was filed under the foreclosure receivership, as entitled to a preference, because bonded interest had been paid out of earnings by the company prior to either receivership. In March, 1874, by an amendment to the claim, a right to preference over the mortgage was asserted under the lien law of the State of Virginia (*Rec.*, 355-366-7-379-80).

The Special Masters, to whom the case was referred, and the Circuit Court in the Fourth Circuit, sustained the claim as against the mortgagees on the latter ground, and rendered judgment accordingly for \$125,067.39, principal, and \$29,828.58, interest, which judgment was affirmed by the Court of Appeals, with additional interest, though on very different grounds. And the case comes here on a writ of *certiorari* granted by the Supreme Court of the United States (*Rec.*, 385-471-565).

The question presented is whether the mortgagees must pay the appellee's claim out of the remnant of the *corpus* of the mortgaged property, there being no surplus of earnings or income whatever under either receivership.

POINTS.

The various decisions of this Court bearing upon the case are recent and familiar. They are cited and discussed in the principal brief on the part of the appellant. It is not proposed again to review them, but only to consider the main question here involved, in the light of the general rules they have

laid down, and the general principles of law applicable to the subject.

I.—The priority of a valid and duly recorded mortgage over subsequent unsecured debts of the mortgagor, is no more open to question in the case of a railroad mortgage than in any other.

The law of the land permits and recognizes such mortgages, and prescribes the method of their execution and record and the means of their enforcement. It thus invites and sanctions advances by the mortgagee, upon the security of the mortgage, which would not be made without it. The money so advanced creates the railroad. A mortgage to secure it is therefore of the nature of a purchase money mortgage.

To give to subsequently incurred debts of the mortgagor a priority over the mortgage, would destroy the principal feature and only value of its obligation. Such a proceeding would be as much in contravention of fundamental principles of law, as of common justice and morality. No State can constitutionally pass a statute having that effect. Nor is it within the judicial power of any Court so to violate a contract.

The language of this Court upon the subject may usefully be referred to. It was found necessary in view of the preposterous claims that had not only been asserted, but in some tribunals, under the demoralization of receivership administration, had been sustained.

Says Mr. Justice BREWER in *Kneeland* v. *Am. Loan & Trust Co.*, 136 *U. S.*, 89: "The appointment of a receiver vests in the Court no absolute control over the property, and no general authority to divest contract liens. Because in a few special and limited cases this Court has declared that unsecured claims were entitled to priority over mortgage debts, an idea seems to have obtained that a court appointing a receiver acquired power to give

such preference to any general and unsecured claims. It has been assumed that a court appointing a receiver could rightfully burden the mortgaged property for the payment of any unsecured indebtedness. Indeed, we are advised that some courts have made the appointment of a receiver conditional upon the payment of all unsecured indebtedness, in preference to the mortgage liens sought to be enforced. Can anything be conceived which more thoroughly destroys the sacredness of contract obligations? One holding a mortgage debt upon a railroad has the same right to demand and expect of the court respect for his vested and contracted priority, as the holder of a mortgage upon a farm or lot. So when a court appoints a receiver of railroad property, it has no right to make that receivership conditional upon the payment of other than those few unsecured claims which by the rulings of this Court have been declared to have an equitable priority. No one is bound to sell to a railroad company or to work for it, and whoever has dealing with a company whose property is mortgaged must be assumed to have dealt with it on the faith of its personal responsibility, and not in expectation of subsequently displacing mortgage liens. It is the exception and not the rule that such priority of lien can be displaced.

We emphasize this fact of the sacredness of contract liens, for the reason that there seems to be growing an idea that the Chancellor in the exercise of his equitable powers has unlimited discretion in this matter of the displacement of vested liens."

This language, from which no member of the Court dissented, has been referred to by the Court and reaffirmed in several subsequent decisions, including the very recent cases of *Thomas* v. *Coal Co.*, 149 *U. S.*, 95, *by Mr. Justice* Shiras, and *Coal Co.* v. *Central Railroad Co.*, 170 *U. S.*, 355, *by Mr. Justice* White.

II.—It is not to be questioned therefore, that in order to displace the lien of a valid railroad mortgage in favor of subsequent unsecured debts of the mortgagor, the consent of the mortgagee, either express or implied, must be shown.

There is no case, there can be no case under the principles of the common law, in which property rights derived under lawful contract can be determined upon any other basis than the true construction and meaning of the contract itself.

And it will be found that in every decision in which any apparent displacement of such a lien has been approved by this Court, it has been founded on what was held to be such a consent.

It constitutes no exception to this rule that the *earnings* of the mortgaged property, before possession taken by the mortgagee, have been treated as belonging to the mortgagor and subject to his liabilities.

Nor that the *earnings after possession*, taken through a receiver, have been treated as applicable in the discretion of the court to the necessary expenses of the receivership, and the preservation of the property.

III.—Various untenable theories have been set up upon which the consent of the mortgagee to the displacement of his contract lien was sought to be derived.

1. It has been claimed that a mortgagee who applies for a receivership consents to all conditions, however arbitrary and unjustifiable, which the Court in granting it, or at any time afterwards, may think proper to impose, and may therefore be required to postpone his mortgage to all subsequent debts of the mortgagor. Which amounts to this, that by seeking to enforce through legal proceedings the lien of his mortgage, he is to be taken as consenting to its illegal destruction.

This proposition is sufficiently refuted by the decision of this Court above quoted.

The discretion to which an application for a receivership is addressed, is a judicial and not an arbitrary discretion, and must be exercised in accordance with the settled rules of law.

If the complainant is not justly entitled to the remedy he seeks, he cannot obtain it upon any conditions. While if he is entitled to it, he cannot be required to pay third persons for it, by the relinquishment in their favour of any part of his contract rights.

It has been said that a complainant coming into a court of equity for relief, must do equity. This is a maxim of universal application. But like most attempts to embody principles in what are called maxims, misleads more frequently than it enlightens. The equity thus intended is not an arbitrary or general moral equity, to be measured by the length of the Chancellor's foot, nor any equity at all in favour of those not parties to the cause, or to the contract on which the cause depends. It is the equity which parties to the cause and the contract have a legal right to demand from the one who is enforcing his legal rights against them. It does not create new liabilities against the complainant, nor require him to pay the debts or redress the hardships of strangers for which he is not responsible, as a condition of obtaining the justice to which he is entitled against those with whom he has contracted. It only enforces his pre existing liabilities, arising out of his contract or its just implication, in favor of those against whom he is proceeding.

2. It has likewise been claimed that if a mortgagee upon foreclosure is shown to have received from the mortgagor any interest upon the mortgage debt as it fell due, while the mortgagor remained in possession of the property, the money so paid will be treated as having been improperly withdrawn from a fund that should have been reserved to meet the

subsequently accruing unsecured debts of the mortgagor, in case of his insolvency; and that an implied promise to refund it by paying those debts out of the mortgaged property will be thereby raised against the mortgagee.

This proposition arises out of the theory that has made progress in some quarters, but which as before seen has been repudiated by this Court, that the legal effect of a railroad mortgage is, instead of giving the mortgagee the priority of lien for which it expressly provides, to postpone him to all other subsequent creditors of the mortgagor, who must first be paid out of the mortgaged property before the mortgagee can receive anything. So that instead of obtaining by his mortgage a prior lien upon the property it covers, he becomes by its operation the only creditor of the mortgagor who has no security at all.

It is plain that while the road remains in the hands of the company, the mortgagee who receives payment of his interest when it accrues, receives only what he is legally entitled to, and cannot afterwards be deprived of, and incurs no obligation to other unpaid creditors.

There is no more reason why he should refund the just payment he has received, in order to pay subsequent creditors, than there is why they, if paid, should refund their money in order to pay him.

Mortgage interest, as much as the operating expenses of a railroad, is necessary to be paid in order to retain possession of the property itself. And it might as well be claimed that one general creditor for supplies should refund his payment in order to pay another, as that the mortgage creditor should refund his interest to pay for supplies. His claim as mortgagee is at least as good as that of any subsequent unsecured creditor.

It will be observed that no interest was paid on the mortgage in question in this case, after April 1, 1892, which was prior to the first receivership, and

fifteen months before the commencement of the foreclosure suit and the appointment of the receivers therein.

IV.—In two classes of cases only has this Court held that there is an implied contract on the part of a railroad mortgagee to pay any part of the subsequent unsecured debts of the mortgagor, or to furnish any money to be used for that purpose.

These exceptions stand upon entirely different grounds, and will be considered separately.

1. It has been held that as a railroad is "a going concern," and as an abrupt stoppage of its operation upon default under a mortgage upon it would be a great detriment to the property, it may be implied that it was the intention of the mortgagee and therefore the fair construction of his contract, that in such an event the receiver appointed on his motion to take possession of the road and to run it under the order of the court, should, as an almost necessary condition, pay out of the earnings those debts due for indispensable operating expenses, such as labour and current supplies, as had accrued within a very short time before the receivership.

That time has never by this Court been extended beyond a few preceding months. And in almost every case where such a payment has been approved, the Court has taken occasion to remark that its allowance constituted the exception and not the rule, and must be granted with great caution.

It will be seen from the record that the claim of the appellee in the present case cannot be brought within the rule thus established, either in the character of the debt, the time and circumstances within which it was contracted, or the party in whose behalf it exists.

(*a*.) The demand is not for labour, nor for ordinary current supplies necessary to the operation of the

road. It is a merchandise debt, upon long credit, for a large quantity of iron used *for reconstruction purposes*, and mostly, as the record shows, upon various roads in several other States than the one in which the mortgagor is incorporated, some of which roads are not covered by the mortgage.

A perusal of the language of this Court in the series of cases involving the question of the character of the debts that have thus been allowed a preference, will show that in no case has any warrant been given for affording it to such claims as this. Such have always been treated as " debts due general creditors, entitled to no special equities."

A debt for the purchase of a locomotive was expressly so held (99 *U. S.*, 258).

The rental of cars was in repeated cases held to be entitled to no preference (136 *U. S.*, 89; 149 *U. S.*, 95).

Materials for construction purposes were excluded (99 *U. S.*, 389).

And in a case in the Circuit Court of Appeals, Chief Justice FULLER presiding, the very claim here in question for steel rails was disallowed (58 *Fed.*, 473).

The claims entitled to preference have been described as " the current debts, the daily and monthly expenses " (per Justice HARLAN, 36 Fed., 808), as "a favored class "; " materialmen and labour men and some few others of that nature " (137 *U. S.*, 171), as "the exception and not the rule " (125 *U. S.*, 658), as "a few special and limited cases " (136 *U. S.*,); " the discretion should be exercised with very great care " (106 *U. S.*, 286).

(*b*.) Nor was this debt incurred within any period of time that has ever been sanctioned by this Court as entitling claims to preference.

That time has, in many cases, been limited to ninety days. In others, four months has been the

limit. In no case has the period been extended beyond six months.

It has repeatedly been held that "if a person permits a claim to continue longer than that, he has no right to be considered other than a general creditor." And that it "may fairly be presumed that he has ceased to look to current receipts for payment."

The theory on which the implied contract by the mortgagee to pay said claims is derived is, that they are for the immediate necessities of operating expenses, in order to prevent a stoppage—supplied by those who look to the immediate receipts for payment; and therefore of no greater amount than the earnings of the road in the receiver's hands would ordinarily be sufficient to pay.

It will be seen from the record that the iron in question was delivered between July and October, 1891, under a written contract for ten months' credit, and notes taken for it, which were several times renewed under the stipulations of the contract, the present notes bearing date between March 21st and June 7, 1892. The first receivership granted in the suit of the general creditors was June 11, 1892, nearly a year after the delivery of the iron. And the mortgagee's receivership was granted July 17, 1893, nearly two years after that delivery, and from one year to sixteen months after the maturity of the last renewal notes now in question.

(*c*.) Regard has also been had in determining the right of preference of such claims, to the parties to whom they are due and the circumstances under which they arose. And the preference has been accorded to those only, who furnishing indispensable supplies relying upon immediate current earnings for payment, are not in a situation to be presumed to know that those earnings may be suddenly diverted by a receivership, or brought to an end by the stoppage of the road.

This is but the application of the general rule that

where the question is whether an implied contract exists, all the circumstances of the case must be taken into consideration.

This Court refers to such claimants as "a favoured class"—as "materialmen, labourers and some few others of that nature" (137 *U. S.*, 171).

No creditor could be farther outside such a class and its equities, than a great corporation delivering hundreds of thousands of dollars worth of iron for reconstruction, two years before the receivership, on a credit of ten months.

It is easy enough to say that any legitimate debt contracted in the course of the operation of a railroad or the prosecution of its business, or the reconstruction of its worn out or destroyed property, is necessary to its maintenance as "a going concern"; and that the time when and the party in whose favour it is contracted are immaterial, so long as without fault of the creditor it has never been paid. In one sense that is true. But that is not the question that arises when it is proposed to give the subsequent debts of the railroad company priority over an antecedent mortgage.

As the mortgage is valid and duly recorded, and is express and explicit in respect to the paramount lien it creates, and as the money which called the road into existence has been advanced on the faith of that lien, it is necessary in order to supercede it (as has been already remarked) to reach that result in accordance with and not in violation of the contract. In other words, to find in its terms either the express or the implied agreement of the mortgagee to that effect. In the very limited class of very recent claims indispensable to the daily operation of the road, and to prevent a stoppage of traffic upon it, such an agreement has been held to be implied in favour of those relying upon it.

The extent of that implication, therefore, must be the criterion in determining what claims can be

given a preference over the mortgage. It is obvious that if the claim here involved has it, there is absolutely no debt honestly contracted by a company in the administration of the railroad and its business, that is not entitled to the same preference, and for an equally good reason.

For it will be found impossible to state any line of distinction between this and any other debt of the company so contracted.

The real question on this branch of the case is, then, whether the Court in construing the mortgage can hold it to be the legal effect of its terms, that instead of the prior lien it provides for to secure the money borrowed on the faith of it, the mortgagee shall have no lien at all. That he shall be the last instead of the first creditor to be paid.

Will it be seriously contended that such is the fair legal construction of this mortgage, or the real intention of the parties? Or that any decision of this Court has given countenance to such a construction?

Or can any legal ground be stated other than the express or implied agreement of the parties to the contract, upon which this claim can be given priority over the mortgage?

Were the law on this subject other than what it is, the mortgagor would be exonerated from the obligations of his mortgage to the same extent that the mortgagee would be deprived of its protection. As soon as the money loaned on its security was obtained, the borrower could proceed to contract subsequent debts to the full value of the property, which would have priority over and defeat the mortgage.

And in the present case, if claims of the character of that presented were large enough to exhaust the small remnant now left for the mortgagee, he might be left on the foreclosure of his mortgage, without any satisfaction at all.

2. It has also been held by this Court, that where earnings of a road have been diverted by a receiver from the payment of debts incurred for its operating expenses, and have been expended upon the permanent improvement of the road, a creditor for such a debt incurred on the mutual understanding that it would be paid out of the current earnings, is entitled to be paid to that extent out of the subsequent earnings in the hands of the receiver, in priority to the mortgage (*Coal Co.* v. *Cen. R. Co.* 170 *U. S.*, 355).

That there has been such a diversion, and that the debt for which the preference is claimed is one that should have been and was agreed and expected to have been paid out of the current earnings so diverted, and that there is income in the hands of the receiver to pay it, are facts which must be established by the claimant, on whom is the burden of proof.

The claim in the present case is not brought by the evidence upon either of these points, within the rule laid down by the Court.

(*a*.) There has been no such diversion of earnings.

It is to be observed in the first place that the mortgagees are not responsible for the proceedings under the first receivership.

That was granted upon the application of general creditors, in a suit to which the mortgagees were not then a party, and before any default had occured under the mortgage. With the bringing of the suit, or the appointment of the receivers, the mortgagees had nothing whatever to do, nor were they interested in its result, or entitled under any circumstances to the earnings in the receivers' hands.

It is true that they subsequently became parties to the cause, but they could not have been heard in opposition to orders of the court respecting disbursements of the receivers, because they had no interest in the income, or the business, and as mort-

gagees before default had no real standing in court in a suit that did not attack or question their mortgage rights.

It has been erroneously assumed by the court below, that the two receiverships were in some way not defined, connected together, with a view to a reorganization of the company. There is not a word in the record to support such an assumption, and it is an entire mistake in point of fact. A comparison of the bills filed in the two cases will show that the relief sought is altogether different, and that the bill of the general creditors could in no respect benefit the mortgagees (*Record*, 1 *to* 19; 223 *to* 239).

The consequences to the mortgagees resulting from it were only to impose upon them a heavy charge for the debts and expenditures of the receivers appointed under it. Nor was there any attempt or scheme for reorganization till after the first receivership had closed.

It is true that the two receivers under the first receivership were, after the close of that and their discharge, reappointed, with one other person, receivers in the foreclosure suit. This was only because they were familiar with the business of the system, and had shown themselves capable of managing it.

The suits were subsequently consolidated. But that was upon the motion of *the appellee in this case*, upon grounds and for purposes connected only with the claim here in question, and which did not justify the consolidation, and against the protest of the appellant (*Rec.*, *pp.* 359-362-364).

This Court has repeatedly held that mortgagees are not chargeable with the consequences or liabilities of a previous receivership at the suit of general creditors, and cannot be held to restore income diverted by such receivers under orders of court or otherwise.

Kneeland v. *Am. L. & I. Co.*, 136 *U. S.*, 89; *Morgan* v. *Railway Co.*, 137 *U. S.*, 171. *And see also to the same effect Swayne* v. *R. Co.*, 46 *Fed.*, 38;

Bound v. *S. C. R. Co.*, 47 *Fed.*, 33; *Street* v. *R. Co.*, 59 *Fed.*, 25.

It will be seen from the record, that the foreclosure receivers received nothing whatever from the former receivership, either in the payment of interest or otherwise, but on the contrary were compelled to pay out of the *corpus* of the mortgaged property a very large amount.

They received from the former receivers, balance in their hands	$141,325 19
And collected from the earnings of the former receivership	393,842 76
	$535,167 95
But they were compelled to pay on the debts and liabilities of the former receivership	$1,237,196 22
And also the certificates of the former receivers authorized by the court before the mortgagees became parties	1,000,000 00
	$2,237,196 22
Making a balance paid by the foreclosure receivers for the liabilities of the former receivership, of. *Rec.*, *p.* 280, *pp.* 403-04.	$1,702,028 27

It is quite clear, therefore, not only that the mortgagees themselves under their receivership diverted no earnings of the road from its operating expenses, but that they repaid out of the *corpus* of the remnant of the mortgaged property this large sum, that had been used for all purposes by the former receivers over and above their receipts, under orders of the court.

There is no evidence in the case to show that any such amount as was so repaid had been expended by the former receivers for permanent improvements. And the contrary is rendered probable by such proof as there is. So that if any such improvements were

in fact made by the former receivers, they were not made out of, but in excess of earnings, and were more than repaid by the mortgagees.

Hence, even if the mortgagees are made chargeable with the proceedings and liabilities of the former receivers (as we respectfully submit they cannot be), there is no money in their hands that in any view of the case would be applicable to the appellee's claim.

The decision of the Court of Appeals was based upon an entire misapprehension of the figures above given. That court did not hold that the appellee's claim should be paid by the mortgagees out of the *corpus* of the property, as must necessarily be the case if it is paid at all. But they held that *the earnings* which they erroneously conceived to be in the hands of the receivers were applicable to the payment of it, on account of the previous diversion of earnings by the Clyde receivers, and by the railroad company while in the possession of the road. And they overlooked altogether the million of dollars of the Clyde receivers certificates which the mortgagees were compelled to assume.

(*b.*) Nor is the claim of the appellee shown to have been contracted in just reliance upon the current earnings of the company, so as to be brought on that point within the decision in *Coal Co.* v *Central R. Co.*, *supra*.

In one sense, it is true, all incurred debts of a railroad company may be said to be contracted in expectation of payment out of its earnings, because it has no other ultimate resources. If that expectation were sufficient, no such distinction as that pointed out by the Court in the case referred to would exist, and all debts would stand on the same footing. But that decision admits the right of preference on account of a diversion of current earnings, only in such supply claims as ought to be paid, and are actually expected to be paid out of current

earnings, and which would have been so paid but for the diversion.

The amount, the nature and circumstances of the appellee's claim, and the long credit contracted for, show that such was not the expectation on either side. The debt was not for operating expenses, but for reconstruction, and could not have been paid or reasonably expected to be paid out of current expenses.

It has already been pointed out, that this demand was not presented under the order of the court in the first receivership, which directed the payment of supply debts that had accrued within six months, as being entitled to share in such payment. That when filed later, no right of preference was asserted for it (*Rec.*, *p.* 355); that not until February 24, 1894, under the foreclosure receivership, was that right set up, and then only upon *the earnings* in the hands of the receiver, and upon the ground that earnings had been diverted by *the company*, while running the road prior to any receivership, to *the payment of mortgage interest* (*Rec. pp.* 366-7); and that afterwards, by amendment (March 12, 1894), the right to a statutory preference was set up under the law of Virginia (*Rec.* 379-80). It was upon this last ground, overruling the others, that the decision of the Special Master and the Circuit Court proceeded, in allowing a piority to the claim (*Rec.*, *p.* 385, *p.* 471).

It cannot be maintained under these circumstances that the claim was agreed or expected by the parties to be paid out of current earnings which have been diverted to permanent improvement. It is itself a claim for permanent improvements. If current earnings had been used to pay it, a creditor for supplies for operating expenses might have demanded a preference on the score of such a diversion.

If any debt of the management can be regarded as contracted on the general and long credit of the company, surely it was this.

(*c.*) Nor is there any surplus of earnings in the hands of the receivers, or of the mortgagees. The balance on income account, as already pointed out, was largely the other way.

If the appellee's claim is to be paid, therefore, it must come out of the pocket of the mortgagees, and would represent nothing that they have received.

V.—The appellee's claim is not entitled to a preference under the statute of Virginia.

1. A large part of the mortgage debt was contracted prior to the passage of that statute. And it will not be claimed that the subsequent passage of the act could confer a lien that would be prior to the mortgage, so far as that branch of the debt is concerned.

2. As the mortgage itself was executed and recorded before the act, and provided for the issue of the entire amount of bonds now outstanding, upon an indivisible security that under settled rules stands for the whole debt equally and alike, the statute lien subsequently authorized could not take precedence of *any part* of the mortgage debt.

Especially as all the bonds under the mortgage were issued and outstanding before the appellee's claim accrued (*Rec.*, *pp.* 387–389).

It is the general rule that a mortgage given to secure future advances takes precedence of a subsequent mortgage, in respect to all such advances as are made before the subsequent mortgage is recorded. And the same principle applies to a lien created or provided for by statute.

3. Nearly all the rails furnished by the appellee were used upon roads outside of the State of Virginia (*Rec.*, *p.* 382). The lien under the statute at-

taches only to the property upon which the labour or materials are expended, if within the State. The act can confer no lien upon property without the State, nor upon any within it, for work done upon other property beyond its jurisdiction.

There can be no such thing as a lien upon a railroad in Virginia, under a statute of Virginia, for supplies furnished on a railroad in Georgia, whether both roads belong to the same party or not.

4. Other satisfactory reasons against the lien claimed under the Virginia law will be found, if desired, in the principal brief for the appellant. No effect was given to this statute as having any application to the case by the Court of Appeals below.

VI.—Interest upon the claim of the appellee to the amount of $29,828.58 was improperly allowed, by a divided court (*Rec., pp.* 471–498). The decisions of this Court are against it.

Thomas v. *Car Co.*, 149 *U. S.*, 116;
N. Eng. Co. v. *Steel Co.*, 75 *Fed.*, 54.

E. J. Phelps,
Of Counsel.

No. 39. 8.
Brf. of Crawford & Smith. Co.

Filed Oct. 7, 1898.

Supreme Court of the United States.

39.

SOUTHERN RAILWAY COMPANY,
Appellant,

vs.

CARNEGIE STEEL COMPANY, LIMITED,
Appellee.

Certiorari TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF FOR THE APPELLANT.

HENRY CRAWFORD,
WILLIS B. SMITH,
Solicitors.

E. J. PHELPS,
Of Counsel.

BARNARD & MILLER PRINT, CHICAGO.

Supreme Court of the United States.

No. 278.

SOUTHERN RAILWAY COMPANY,
APPELLANT,

VS.

CARNEGIE STEEL COMPANY, LIMITED,
APPELLEE.

Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

Statement and Brief for Appellant.

The *certiorari* allowed by this Court brings up for review the decision of the Circuit Court of Appeals for the Fourth Circuit, awarding to the Steel Company's intervention for rails sold to the Richmond and Danville Railroad Company, a priority over its mortgage bonds, and ordering the principal and interest of such ante-receivership claim for rails to be paid as a preferential debt out of the proceeds of sale of the mortgaged property. (76 Fed. R., 492.)

The Richmond and Danville Railroad Company was a Virginia corporation, owning a line of railroad exclusively in that State which extended from Richmond to Danville, 152 miles.

Through leases, stock ownership and working contracts it controlled and operated 3,168 miles of addi-

tional railroad belonging to 26 other corporations, constituting an important system between Washington and the Mississippi River.

The railroad company had executed three mortgages on its road; in 1874 a first mortgage for $6,000,000; in 1882 a debenture mortgage for $4,000,000; in 1886 a consolidated mortgage for $4,527,000; also in 1889 a mortgage covering certain equipment and other property for $1,390,000, and in 1891 an equipment trust mortgage for $883,000.

On June 16, 1892, Clyde and others, as stockholders and creditors, filed a bill in the Circuit Court for the Eastern District of Virginia against the railroad company, alleging its insolvency and praying for a sequestration of all its property.

The mortgagees were not made defendants to the bill nor was there any default in interest upon any of the bonded debt when such suit was instituted.

The Court on the same day appointed temporary Receivers of all the railroads and assets of the corporation, including all its leased, controlled and operated lines with instructions to take possession and continue the operation of the system.

Out of the earnings coming into their hands, the Receivers were authorized to pay their own current expenses of operating the roads, traffic balances and also "to pay and discharge all the current and unpaid pay-"rolls, vouchers and supply accounts incurred in the "operation of said railroad system at any time within "six months prior hereto" (Record, 22).

On June 28, 1892, the complainants filed a petition in the cause showing that the ante-receivership supply bills

coming within the scope of the order would amount to about $1,000,000, and were being pressed for payment, that the first mortgage interest and rentals on leased lines accruing on July 1, 1892, would require about $938,687 and the net earnings of the system would not be sufficient to discharge such preferential debts and also pay the mortgage interest and rentals.

They therefore prayed that the preferential debt should be capitalized by an issue of Receiver's certificates so that the current income might be used to pay bond interest and rental of leases (Record, 26).

The Court made an order on this showing, authorizing the issue and sale of $1,000,000 Receivers' certificates, which were decreed to be a first lien upon the railroad, leaseholds and income, the proceeds of which were to constitute a special fund to be used exclusively to pay off the preferential operating debts of the system incurred within six months prior to the receivership. Such claims were to be paid only upon the audit and approval of Special Masters who were appointed by such order.

The Receivers were also instructed, until further direction, to pay all maturing car-trust installments and the rentals of leased roads. The Court, reserved full power to set aside or modify such order on the application of any party in interest (Record, 134, 137).

On August 12, 1892, the Receivers filed a report showing that, under their order of appointment, they had taken possession of and were operating 3,320 miles of railroad and 200 miles of steamer lines, and stated in detail the mortgage, leases and rental obligations of the system.

They also reported that on their taking possession on

June 16, 1892, they had received from the railroad company the sum of $480,427.91 cash; the ante-receivership labor rolls then unpaid amounted to $619,596.59; the outstanding liability for taxes, six months' supplies, traffic balances, &c., was $1,244,510.93; the floating debt was $4,434,450, secured by pledge of bonds and stocks aggregating a par value of $9,924,100; there were car trusts, $895,100, and an emergency loan of $567,000.

Of the Receivers' certificates authorized by the order of June 28, 1892, they had sold $684,964.38.

They also submitted a statement of the various payments they had made for rentals of leased railroads and equipment, amounting to a total of $860,814. (Record, 154.

On August 16, 1892, the provisional Receivers were made permanent, and vested "with all and singular the "rights, powers, titles, duties and obligations set forth "in and by their original order of appointment, and the "orders supplemenal thereto heretofore entered in this "cause."

No motion was ever made by the appellee or other supply creditor to enlarge the six months' limitation beyond which ante-receivership debts were not to be paid. No objection was ever filed against the continued operation of the leased lines or the payment of rental therefor during the Receivers' *actual* occupancy or any modification sought of the orders directing their continuance.

Special masters were appointed on August 16, 1892, to take the necessary accounts and report "the amount "and nature of all the indebtedness of the said Rich- "mond and Danville Railroad Company and whether "secured by mortgage, pledge or other lien upon any

"portion of the corporate property," etc., and all creditors (except the holders of bonds secured by recorded mortgage) were required to file their respective claims with the special masters on or before December 1, 1892, "to the end that the validity, amount and respective priorities upon the property or income thereof may be determined and reported on by the special masters to the court." (Rec., 173.)

The Carnegie Steel Company, Limited, on October 14, 1892, appeared in the cause, and filed with the special masters its verified claim of debt for $125,067.39 and interest, upon five promissory notes of the railroad company, dated in March, April, May and June, 1892, executed and payable in New York.

It was alleged generally in such proof of debt that the notes were given for steel rails, but the contract under which such material was furnished was not exhibited or stated. No claim was made either of a statutory or equitable lien against income, nor was any showing made that the debt was within the six months class, or constituted anything but an unsecured liability. (Record, 355.)

On October 27, 1892, an amended claim was filed, showing that the rails were delivered in July, August and October, 1891, under contracts of June and October, 1891. No claim of lien or preference was asserted in this amendment. (Record, 358.)

On October 1, 1892, the first default occurred in the payment of interest upon the consolidated bonds of the railroad company secured by its third mortgage executed in 1886.

On July 17, 1893, the Central Trust Company filed its

original bill to foreclose, subject to prior liens, the consolidated mortgage executed by the Railroad Company to it, as trustee, on October 22, 1886, covering its main line of railroad, divers leased lines and also certain pledged bonds of other roads (Record, 223). This third mortgage was largely a mere refunding of prior bond issues.

The bill averred that $4,527,000 of consolidated bonds had been issued for value, and were outstanding in the hands of innocent holders.

Of these, $350,000 had been issued for new equipment, $719,000 had been issued in exchange for debentary bonds, secured by the second mortgage of 1882, and $632,000 for debenture coupons, and $2,826,000 to acquire $2,844,000 first mortgage bonds of eleven other railroad corporations. By the express terms of the mortgage such debenture and first mortgage bonds constituted a part of the securiry covered by the consolidated mortgage and were lodged uncanceled with the trustee. The insolvency of the mortgagor and the inadequacy of the security, and default in coupon payment in October, 1892, and April, 1893, were alleged. The bill prayed for foreclosure and sale subject to prior liens and the appointment of Receivers in the mortgagee's suit so as "to secure the earnings of the railroads to the use of the bondholders." (Record, 238.)

The Court on the same day appointed Receivers under the foreclosure bill, and ordered the Receivers in the Clyde suit to deliver on August 1, 1893, all property and money in their hands to the mortgagee's Receivers, who were required to take over the assets and pay all the just debts and liabilities of the first set of Receivers under the stockholders' bill. (Record, 240.)

The outgoing Receivers in the Clyde suit, on August 21, 1893, filed a report showing their transfer of possession to their successors appointed under the foreclosure bill and asked for the audit and approval of their accounts and final discharge. (Record, 218.)

An order of reference was entered on the same day. (Record, 219.)

Up to the time when the first Receivers were discharged from possession and the passage of their accounts directed, the appellee had intervened solely as an unsecured creditor, had asserted no claim of lien or preference, and had made no objection to the disposition of the receivership income according to the court's orders.

The Special Master charged with such audit filed his report on March 3, 1894, covering all receipts and disbursements for the entire period of the original receivership in the Clyde suit (Record, 220).

It showed that such officers had paid out of their own receipts and earnings operating debts incurred by the mortgagor during the six months immediately prior to the receivership:

Traffic balances	$122,493 78
Loss and damage claims	75,062 65
Pay rolls	602,287 89
Material, supplies, &c	437,351 90
Making a total payment of ante-receivership debts of	$1,237,196 22

The report shows that the receivers, on their appointment, received $480,427.91, and collected from ante-receivership earnings $671,363.40, making a total of 1,151,791.31.

The Clyde suit receivers, therefore, not only paid out all the cash received and collected from the earnings of the company before suit brought, but also applied $85,-404.91 of their own current income to the discharge of the operating debts of the company created before suit brought.

These sums were exclusive of the proceeds of the $1,000,000 receivers' certificates which were charged upon the mortgaged property and paid out of the sale proceeds.

The report further shows that the original Receivers had disbursed, under specific orders of the court, $3,253,-956.89 for interest and rentals, and $481,893.16 for car rental payments (Record, 222).

No exceptions were ever filed to such master's report by appellee or any other creditor, and the same was confirmed on April 13, 1894, and the accounts of the first receivers from June 16, 1892, to July 31, 1893, as stated in their report, were fully accepted and passed, and they and their sureties finally released and discharged (Record, 222).

On February 12, 1894, the Carnegie Steel Company, Limited, filed a formal petition in the foreclosure suit brought by the Contral Trust Company, alleging its proof of debt in the original stockholders' and creditors' suit, the subsequent institution of the foreclosure action and the discharge of the first set of receivers and transfer of the properties to Receivers on the foreclosure suit.

It prayed the two causes might be consolidated.

In this application it was for the first time claimed in general terms that its demand should be allowed " equitable priority of payment over the mortgage debt " (Record, 359).

An order consolidating the two causes was passed February 17, 1894 (Record, 364).

March 1, 1894, the Steel Company filed another petition in the consolidated cause, stating more at length the particulars of its claim.

It alleged the rails were sold to the railroad company under a written contract dated June 10, 1891, and were laid in its roadbed.

It contended that it was a supply creditor equitably entitled to have the earnings of the railroad applied to the payment of its claim.

It charged that, both before and after the appointment of Receivers in the Clyde suit, large sums of money were paid out of earnings for interest upon mortgage bonds by reason whereof its claim had remained unpaid.

It claimed that by reason of such diversion of income it had a lien on the mortgaged premises prior to the consolidated mortgage, sought to be foreclosed, and asked to be made a defendant. Copies of the rail contract of June 10, 1891, and the unpaid final renewal notes were made exhibits. The rails were sold on four months' credit with the privilege of two renewals of three months each (Record, 365 to 384).

Appellee was made defendant, and its petition ordered to stand as an answer to the foreclosure bill (Record, 375).

March 8, 1894, the Central Trust Company, mortgee, filed its answer to such intervening petition alleging that only a portion of the rails were laid in the Danville road, and denying that the claim had any equitable priority over the consolidated bonds, either as to the railroad, its income or the proceeds of sale, but was a mere

merchandise debt contracted exclusively on the personal credit of the Railway Company (Record, 375).

March 16, 1894, appellee filed another amendment to its intervention averring that its claim for rails sold, under Section 2485 of the Code of Virginia, constituted a statutory lien on the franchises, gross earnings, and all the real and personal property of the Richmond and Danville Railroad Company with a priority over the consolidated mortgage of 1886 (Record, 379).

The Special Masters on April 10, 1894, reported as to the amount of the mortgage and other indebtedness (Record, 253).

The debt secured by the consolidated mortgage was stated by them to be as follows:

Interest due October 1, 1892	$113,183 75
" " April 1, 1893	113,183 75
Principal..........................	4,527,350 00
Total	$4,753,717 50

A final decree of foreclosure and sale upon the consolidated mortgage was entered April 13, 1894 (Record, 262 to 282).

It was adjudged that the mortgage of October 22, 1886, was legally executed, acknowledged and recorded; that the bonds, coupons and scrip issued thereunder and secured thereby were a valid lien upon the railroads, leaseholds, mortgage bonds and property therein described, and were all equally entitled to the security of said consolidated mortgage.

The amount of the mortgage debt due at the date of such decree was found to be $5,002,155.81.

The railroad, seven leasehold estates, stocks and bonds described in the mortgage were ordered to be first offered for sale in parcels and then as a unit.

It was expressly provided that the purchaser could renounce any lease described in the mortgage.

The Court reserved the right to require the purchaser by supplemental order to pay all such claims as should be finally decided to be "prior in lien or superior in equity to the mortgage foreclosed in this suit," with the power to retake and resell the property, in case the purchaser should fail or neglect to comply with the Court's order in respect to the payment of any such adjudged prior lien claims. The purchaser or assigns were invested with all the rights of the mortgagee as to resistance of the priority of any such intervention and authorized to appeal from any decree giving it priority.

The net proceeds of sale were ordered to be applied first to the payment ratably of the interest due and unpaid upon the consolidated bonds, and thereafter to the principal of such bonds.

The purchaser was expressly obligated to pay off and satisfy the receiver's certificates issued under the order of June 28, 1892, and all current operating debts and liabilities of the receivers.

No exceptions were ever filed to such decree. No modification or appeal was ever prayed therefrom by the appellee.

The railroad, equipment, bonds, stocks, leases and other property were sold under this decree as a single parcel, on June 15, 1894, to the appellant for $2,030,000. (Rec., 289.)

The selling masters reported that the purchasers de-

clined to accept the leasehold estates in the Columbia and Greenville, the Charlotte, Columbia and Augusta, and the Richmond, York River and Chesapeake Railroads. (Rec., 291.)

Such sale was confirmed without objection.

In provisional satisfaction of its bid the purchaser paid into court $75,000 cash, and $4,513,000 par value of consolidated bonds, with attached unpaid coupons and $280 in bond scrip.

The court, in the decree of confirmation, again reserved power to charge the property sold, for the payment of receivers' certificates or liabilities or corporate debts prior in lien or equity to the lien of the mortgage foreclosed, as had been originally provided in the foreclosure decree of April 13, 1894. (Rec., 297.)

Conveyance was executed by the masters and possession of all the property sold was delivered by the receivers to the appellant on June 30, 1894. (Rec., 301.)

The Receivers fully reported at the same time the financial condition of their trust. Their cash and collectible cash assets were estimated at $480,000, while their liabilities for operating, labor and supplies were stated to be almost $1,005,145.50 (Record, 301).

July 13, 1894, the Court ordered the purchaser to pay into the registry $455,144.50 cash, to be applied on the balance of unpaid mortgagee Receivers' payrolls and supply debts over and above their cash assets (Record, 306).

On May 19, 1894, the Special Master reported on appellee's intervention that the five renewal notes held by it were a just debt of the railroad company; but such claim was not entitled to any equitable priority over the

mortgage bonds on the authority of the judgment of the Circuit Court of Appeals in *Bound* v. *South Car. R. R.*, but they reported that it constituted a statutory lien under the Code of Virginia upon the proceeds of sale, inferior to $1,621,000 of the consolidated bonds which had been actually issued prior to May 1, 1888, when such Code went into effect, and was superior in lien and right of payment to the remaining $2,906,000 of such consolidated bonds which were issued after the Code took effect (Record, 381).

A stipulation as to the dates of the original issue of the consolidated bonds by serial numbers and the full oral and documentary evidence submitted in the Master's office accompany the report (Record, 386 to 468).

The main rail contract was in writing, executed June 10, 1891, for the sale of 2,500 gross tons steel rails "delivered on board cars at Bessemer, Pa." in July, 1891 (Record, 370, 381).

The railway company agreed to accept all rails so delivered and "to pay" therefor $30 per gross ton "in its notes at four months from date of shipment without interest," upon presentation at its office, 80 Broadway, New York, N. Y., of invoices and bills of lading covering the same."

The railroad company was to have the privilege of one renewal of its paper for three months, at five per cent. interest and a second renewal for three months at six per cent.

It also had the option of increasing the contract quantity by 200 or 300 tons.

July 21, 1891, 1,656 tons were contracted for at same price, terms and delivery.

October 2, 1891, 200 tons second-quality rails were sold at $26 per ton.

The statement shows about 4,203 tons in all were delivered, the contract price being $125,067.39. Except about 184 tons second-quality rails, costing about $4,792, delivered in October, all rails were delivered in July and August, 1891.

The five notes of the railroad company outstanding and unmatured at the date of the original receivership as filed with the intervention, were as follows:

March	21,	1892,	3	months	$38,251.77
"	24,	"		"	35,499.38
April	4,	"		"	12,786.16
May	16,	"		"	5,355.09
June	7,	"	4	"	33,174.99

These were all renewal notes. They bore no interest, showing conclusively that current interest on each extended credit had been paid in cash by the railroad company.

The July deliveries, 1891, amounted to $33,174.99, the exact amount of the outstanding note, dated June 7, 1892, due in four months. (Record, 374.)

The original four-month note of like amount for the July deliveries matured, excluding grace, say on November 28, 1891. The first three-months renewal thereof fell due February 28, 1892. The second three-months renewal would mature May 28, 1892.

Here the contract option as to renewals ended. It is therefore an indisputable and material fact that the four-months note of June 7, 1892, for $33,174.99, was not executed under the contract at all, but was a voluntary

fourth extension of personal credit, entirely outside of the written agreement.

The small note for $5,355.09, dated May 16th, is evidently for the purchase of the second quality rails delivered in October, 1891, under the separate contract of that month, added to the item of $562.50 under date of August 29th.

The masters reported that the rails were laid upon the following roads:

North Eastern of Georgia	1,108	tons,	costing	$33,174 99
Virginia Midland	1,270	"	"	37,713 15
Georgia Pacific	31	"	"	920 56
Richmond and Danville ..	1,793	"	"	53,258 69

The report is an error as to the last item, as clearly shown by the deposition of W. H. Green, general superintendent, who gave the only testimony on the subject. On further examination of his rail chart he corrected his first statement, which was adopted by the masters, and testified that only about one and one-half miles or 175 tons of the rails were actually laid on the Richmond and Danville road, and the remainder of the 1,793 tons were laid in the Piedmont road, which is south of Danville and mainly in North Carolina. (Rec., 482.)

The testimony taken upon the reference is filed with the report (Record, 390 to 467).

The mortgagee filed its exceptions to the Master's finding that the rail claim was a statutory lien superior to any of the consolidated bonds (Record, 468).

The Steel Company filed no exception to that portion of the Master's report which found it had a statutory lien on the railroad which was in all things subordinate to $1,621,000 of the consolidated bonds.

Its single exception challenges the report because the Masters should have given the rail claim priority over all the bonds "on account of diversion of earnings of the said company to and for the benefit of the bondholders and of the holders of securities of said leased and proprietary lines." (Rec., 469.)

On December 16, 1895, the Circuit Court rendered a decree overruling the exceptions of the mortgagee and sustaining the exceptions filed by the Steel Company (Record, 470).

It found that the rails were purchased by the railroad company at the dates and were of the value of $125,-067.39, as stated in the intervention; that they were used by it and were not paid for.

Also,

"that the earnings of said defendant Railroad Company "which should have been used for the payment of cur-"rent expenses, including this claim, have been used for "the benefit of mortgage creditors in a sum more than "sufficient to pay said claim in full."

"Prior to May 1, 1888, bonds of the Richmond and "Danville Railroad Company, known as consolidated "bonds, were issued to the amount of $1,621,000 and "that since that date such bonds have been issued to "the amount of $2,906,000."

It was, therefore, decreed that the priucipal and interest of the claim of the Steel Company, amonnting to $154,895.97, is entitled to priority of payment out of the sale proceeds over all the consolidated bonds.

Also, that such claim and interest,

"by reason of the statutes of Virginia, is entitled to pri-"ority of payment out of the fund resulting from the sale "of the mortgaged property over such of the bonds secured "by the mortgage foreclosed by the decree hereinbefore "passed in this cause as were issued after May 1, 1888, "being $2,906,000 in amount."

The decree in the last clause required the purchaser to forthwith pay $154,895.97, found due for principal and interest on the claim of the Steel Company.

The Southern Railway Company, purchaser, on January 16, 1896, filed its assignment of errors and petition for an appeal from such decree.

An appeal was awarded, *supersedeas* approved, and citation duly issued and served.

On November 10, 1896, the decree of the Circuit Court was affirmed without modification by the Circuit Court of Appeals for the Fourth Circuit, 76 Fed., 492.

The affirmance of the decree in its entirety, of necessity constitutes an unequivocal judicial declaration that the adjudication awarding to $1,621,000 of the foreclosing bonds a priority under the laws of Virginia upon the sale proceeds over the rail claim was without error.

The opinions discuss only such questions as relate to the other branch of the original recovery in the Circuit Court ; that the debt due the intervenor was a supply claim chargeable upon current income and therefore entitled to an equitable priority upon the sale proceeds over all the bonds, because of the misapplication of earnings during the receivership in the Clyde snit.

On application of the purchaser, the record was ordered here for the general review of such judgment of affirmance.

The entire income of both receiverships was used under the express orders of Court, in the payment of current operating expenses, ante-receivership pay rolls, traffic balances and operating supplies, interest on underlying mortgages and rental for such other roads as were actually operated by the Receivers and contributed to their gross earnings.

The appellee became a party to and took the benefit of the original receivership suit.

It made no applicatiou to modify or vacate any of the orders under which the Court disposed of all the receivership income, and thereby adopted and consented to such use of the income.

It filed no exceptions to the Receivers disbursements, and is concluded by the confirmed Master's report thereon against any subsequent contention that such payments were in law a misappropriation of earnings upon which it had the first right.

It made no effort to change the six months limitation, or have the receivership income applied to the satisfaction of its debt.

In truth, it did not even assert any claim of priority either upon income or road until several months after the Receivers in the Clyde suit had been discharged from the possession and operation of the system.

When the original Receivers were appointed in June, 1892, and the order was made to pay the rentals due upon the leased railroads, being operated by the Receivers, no interest was in default upon the consolidated bonds, and there was no subsisting right of action upon either the bonds or the mortgage.

Such bondholders had, therefore, no matured claim upon the current income of the railroad, or any standing in court to control its disbursement, either directly or indirectly, for their benefit as such junior mortgagees.

After the default in interest payment on such bonds on October 1, 1892, this class of mortgage creditors did not personally or by representation apply in or become parties to the Clyde suit.

During its pendency no part of the earnings were used to pay interest upon the consolidated bonds.

The first applicatiou of the consolidated bondholders to assert their lien was the filing of the independent foreclosure bill by their trustee and the appointment of Receivers in July, 1893.

The earnings realized thereunder were exhausted in the payment of current operating expenses, interest on underlying first mortgages, rentals on leased roads, and the deficits of the first receivership.

There were no earnings applicable to the payment of any part of the $1,000,000 certificates issued by the original Receivers for account of the six months' supply debts. This liability was, therefore, carried over, the sale and imposed directly upon the mortgaged property itself as a paramount charge to be paid by the purchaser.

According to the undisputed facts of the record, no interest was paid to the foreclosing consolidated bondholders during either receivership, and their mortgage security was subordinated to $1,000,000 of ante-receivership supply claims, and their income was used to pay a large deficit of the first receivers operations.

The Circuit Court on such showing adjudged that the earnings of the railroad should have been used for the payment of current expenses, including this rail claim, but had been inequitably used for the benefit of mortgage creditors.

FIRST. The court orders appropriating the receivership income expressly excluded the appellee's claim from any participation in the current earnings.

In the original order of June 16, 1892, the court, as it had the undoubted power to do, established a limitation of time, beyond which it would not recognize any claim as clothed with an equity to be paid out of the revenues thereafter coming into the Receivers hands.

Only operating expenses incurred within six months of the appointment were thereby made preferential and charged upon the future income received by the court's officers.

The appellee's claim was excluded by that limitation from asserting any equity whatever to be paid by the Receivers.

If the order establishing a general time limit was inequitable, or if special circumstances existed which might give the appellee's claim an exceptional recognition, it was the duty of the claimant to apply to cancel or modify the order which was conceived to be injurious.

Miltenberger v. *Railroad*, 106 U. S., 286.
U. S. T. Co. v. *Wab. R. R.*, 150 *ibid.*, 304.

Up to the discharge of the first Receivers, the Steel Company made no claim whatever of preference upon income and by its failure to challenge any of the orders authorizing Receivers' disbursements, it consented to such disposition of the earnings.

In the appointment of Receivers in the foreclosure suit it was declared that "nothing in this order contained "shall be construed to vacate any of the orders here-"tofore entered in the case of William P. Clyde and "others."

That provision reaffirmed the original and then unchallenged limitation of six months and expressly excluded the Steel Company from asserting that it ever had any preferential claim against the receivership income, or that such earnings had been diverted as against its superior equities thereon.

The point has been recently decided by the Court of Appeals for the Sixth Circuit in *Cent. Trust Co.* v. *E. T. V. & G. Ry.*, 80 Fed., 624.

A Receiver had been appointed in a creditor's suit. The order limited the Receivers in the payment of supply claims to such as had been furnished within the six months immediately preceding the appointment.

Subsequently a junior mortgage was foreclosed, and divers creditors who had furnished operating supplies more than six months before the receivership sought to establish their claims against the sale proceeds because of alleged diversion of earnings.

It was decided that they had no claim upon the earnings because of the time limitation which was in itself reasonable and clearly within the judicial power to adopt and enforce.

"The appellants present no special circumstances "which will justify a departure from this general order "under which all such claims have been settled, and we "feel altogether indisposed to arbitrarily extend the "limit imposed in the sound discretion of the Circuit "Court."

It was argued below that as the rail debt was represented by notes which had not matured when the receivers were first appointed, the claim should not be considered as incurred so as to be a charge upon income until the expiration of the credit.

The exact terms of the court direction were to use the current earnings to pay "the vouchers and supply "accounts incurred in the operations of said railroad sys- "tem, at any time within six months prior hereto."

The decision last quoted disposed of a like contention.

"For appellants it is further insisted that the order "made by Judge Jackson should be construed as apply- "ing to the time when their claims accrued and that in "respect of at least parts of one or more of their claims, "the supplies were furnished upon a credit of either "thirty or sixty days, and did not fall due until after "January 1, 1892. The order plainly limited the re- "ceivers to the payment of claims for supplies 'fur- "nished' on or after January 1, 1892. The order can "bear but one construction. The time of delivery by "the seller to the railroad company is the time when "they were furnished."

Under the rulings here the Circuit Courts were vested with undoubted power to establish a reasonable limit beyond which claims against the corporation would not be entitled to be protected as "debts against the income."

Claims, to be preferential, must not only be those of the restricted and favor class, but be contracted "a brief period" before the judicial intervention.

Morg. Co. v. *Texas, &c., R. R.*, 137 U. S., 197.

In *Miltenberger* v. *Logan R. R.*, 106 U. S., 280, it was decided that ninety days was a reasonable limit within which operating claims must have been incurred to be allowed as preferential.

This limit has been adopted in railroad foreclosure cases in the Fourth Circuit.

Fin. Co. v. *C., C. & C. R. R.* 52 Fed., 526

Ibid. v. *Ibid.*, 62 *ibid.*, 205.

In *Wood* v. *N. Y. & N. E. R. R.*, 70 Fed., 941, a four months limit was fixed.

In *Thomas* v. *P. & R. I. Ry.*, 36 Fed., 808, Justice HARLAN characterized a limitation of six months "as wise and salutary," and refused recognition to claims incurred beyond such period. "Expenses incurred within such reasonable time constitute what are called "'current expenses,' which ought, if possible, to be paid "out of the receipts during the same period."

"When therefore, debts of that character remain unsettled, or are not put in suit for such a length of time as "would be deemed unreasonable, it may be fairly presumed "that the creditors have ceased to look to current receipts for payment, and have accepted the position of "general creditors, who, as such, need have no claims "for indemnity upon any special part of the income."

Justice BREWER declared on this point:

"Six months is the longest time I have noticed as "given.

"If any person permits a claim to continue longer "than that, he certainly has no right to be considered "other than as a general creditor, with no preference "over a secured debt."

Blair v. *St. L. R. R.*, 22 Fed., 471.

This extreme limit of six months has been adopted in many cases.

> *Union Trust Co.* v. *Soutter*, 107 U. S., 592.
> *Ibid.* v. *Midland Ry.*, 117 *ibid.*, 463.
> *Turner* v. *I., B. & W. Ry.*, 8 Biss., 315.
> *Swayne* v. *W., St. L. & P. Ry.*, 46 Fed., 38.
> *Putnam* v. *J., L. & St. L. R. R.*, 61 *ibid.*, 440.
> *C. T. Co.* v. *E. T., &c., R. R.*, 80 *ibid.*, 624.

These authorities fully establish the proposition that the Circuit Court had undoubted power when it appointed receivers under the Clyde bill, to declare as a fixed principle of administration, that claims for material purchased by and delivered to the corporation more than six months before the sequestration should be regarded as ordinary unsecured creditors, with no right of preference upon the receivership earnings.

The original receivership was administered to its close on that basis, with no change or effort to modify such limitation order and no claim for preference was interposed by the appellee during that period.

Such being the condition of the record the court had no warrant to decree that the rail creditor had any claim whatever to be paid out of the current receivership earnings, or that as to it there was any diversion.

The order distributing the receivership income excluded appellee's claim from any participation and fixed its status as an ordinary unsecured creditor.

It was not competent for the court, long after this receivership had been fully administered in exact compliance with the terms of its unrevoked orders, to decree preference and payment to a claim incurred about a year prior to the first receivership and nearly two years before the foreclosure suit, on the ground that the first receivership earnings were diverted and should of right have been used to pay a claim that was not asserted as preferential and was expressly excluded by the court's order from any participation.

Second. The testimony and accounts demonstrate that there was no diversion of receivership income, so as to raise an equity in favor of the rail creditor, to be paid out of the sale proceeds in preference to the mortgagee.

(1.) It must be conceded that the appellee was not in a position to assert any preference, based on diversion, until its claim matured in October, 1892.

It had no possible claim upon the income for over a year after the rail deliveries, because of the credit extended.

It was contended that at that date, however, the claim, by its mere maturity, was put upon the footing of an operating expense, chargeable against and payable out of the then current earnings.

This proposition lacks any support from principle, analogy or authority.

It would be a strange situation if during 1891 and nearly all of 1892 appellee was a mere ordinary merchandise creditor, with no equity against the current earnings

but that the maturity of its notes pending a receivership clothed it with a fresh equity and right of preferential payment out of the court's earnings.

Such an equity once effectively waived is at an end.

The rule with regard to diversion and "debts of the income" necessarily means that the current income of 1891 should be primarily devoted to the payment of the current expenses of the same period.

In order to question the effect of the receivers' payments out of their earnings, the appellee is forced to claim that the price of its rails, as an alleged current expense of 1891, when they were delivered, was not a debt of the income of that year, but somehow became a preferred charge upon the current earnings from October, 1892, to July, 1893, or later.

By this method the Receiver's current income becomes doubly saddled. It must pay its own operating charges, and, in addition, the once waived rail liability having released the income current at time of delivery, is revived as a current expense specially payable out of earnings coming into the court's hands nearly two years after the debt was incurred.

(2.) The figures presented to establish diversion relate wholly to the administration of the first Receivers, covering the period from June, 1892, to August 2, 1893.

There is no separation of the figures as of October 10, 1892, when the last renewal note matured.

Up to that date it concedes it had no claim upon the earnings. It cannot on any theory go into the accounting prior to that.

There are, in fact, therefore, no accurate or approxi-

mate figures in the record covering the precise period to which the inquiry as to diversion must properly be restricted. Many of the payments challenged were prior to October, 1892.

When the receivers were appointed in June, 1892, the bonds were not in default. The mortgagee did not obtain the receivership.

Its own bill was not filed and Receivers thereunder installed until August 1, 1893.

The consolidated bondholders did not apply for judicial aid or assert any demand for possession, and received no interest from such first receivers, and should not be charged with the responsibility of their operation.

Morgan v. *H. & T. C.*, 137 U. S., 171.

The distinction in the equitable obligations of the mortgage security, where receiverships have been obtained at the instance of the mortgagee, and those granted to stockholders or general creditors, is well settled.

Swayne v. *W. St. L. & P.*, 46 Fed., 38.
Street v. *Mary. Cent.*, 59 *ibid.*, 25.

Until the mortgagees come into equity with their own application for entry they stand on their vested liens and are in no way responsible, out of their contract security, for the court's administration of the property.

Bound v. *S. C. R. R.*, 47 Fed., 30.

No possible equitable accountability to restore income used by a general creditor's receivership can be charged against a non-applying mortgagee.

The bondholders did not enter until August, 1893, and are not directly or indirectly chargeable with the general

policy or results of the anterior receivership or any restoration of alleged diverted income. This is settled by the case of *Kneeland* v. *Am. L. & T. Co.*, 136 U. S., 89.

"They [the bondholders] were not asking it to take "charge of the property, or thus impliedly consenting to "its management of the property for their benefit. "Neither lienholder asking the aid of the court, no "obligation was assumed by either in respect to the "management of the property as against the other."

So far as any equitable accountability of the consolidated bondholders for administration, income, disbursements or deficits is involved, the case, on the express precedent last cited, stands precisely as if the receivership began August 1, 1893.

Until that date the mortgagee had not demanded entry or to harvest the income for their own benefit. If the general creditors' receivership had resulted in large net surplus they could not upon established principles have claimed it under the mortgage. Upon like grounds the supply creditor can claim no equity against the mortgage security by reason of the manner in which earnings were disbursed upon which they had no claim.

The distinction was again recognized and enforced in *Bound* v. *S. C. Ry.*, 47 Fed., 33.

"But the intervenor has no equity as against the "first mortgage and other liens superior to the second "mortgage. These classes of creditors did not of their "own volition come into equity, and the rule cannot be "applied to them to do equity. They can stand upon "their legal vested lien."

Restoration of diverted earnings during the receivership, obtained by a second mortgage was, therefore, refused, as against a non-applying first.

According to the accepted precedents the consolidated bondholders were not chargeable out of their security with the restoration of any diversion during the first receivership, even if such fact was established.

On that footing the appellee has no color of reclamation against the fixed security of the consolidated mortgage.

(3.) Even considering the accounts of both receivership, no diversion of current income chargeable to the consolidated bondholders had been made out.

Dealing generally with the figures reported by the Receivers and explained by Auditor Dunham, it appears, that no interest was paid during either receivership to the consolidated bondholders. Coupons to the amount of over $450,000 on that mortgage, defaulted during the receivership, were included in the foreclosure decree. (Record, 275.) Interest even on the first and debenture mortgages was also unpaid at the end of the receivership, aggregating over $480,000. (Record, 430.)

The opinions in the Court of Appeals state as important that the first Receivers received a large sum of ante-receivership earnings upon which the bondholders had no lien.

Dunham (Record, 399–403) gives the exact figures. The first Receivers collected out of earnings prior to their appointment the following sums:

Cash received on appointment..........	$480,427 91
Collections	671,363 40
"	9,369 66
Total receipts..............	$1,161,160 97

They paid out of their own earnings on preferential labor and supply accounts, traffic balances, &c. (besides the $1,000,000 Receiver's certificate fund), the following sums: $1,237,196.22, and $21,155.39, being a total of $1,258,-351.61, or $97,190.64 in excess of all they received from company earnings.

The Court also stated that the first Receivers paid over a large sum in surplus cash to the mortgagees' Receivers.

This is true. The order in the foreclosure suit treated the road as a going concern, and consequently it required the outgoing Receivers to turn over all their moneys and assets to their successors, and required the latter to pay all the debts and liabilities of their predecessors.

That account stands as follows, as shown by the official report (Record, 426):

Cash received from first Receivers Aug. 1, 1893	$141,325 19
Collections on first Receivers' accounts	9,309 66
	384,473 10
Total	$535,167 95

The mortgage Receivers paid the following operating liabilities of the first Receivers (Record, 427):

Traffic balances	$53,257 20
Damage claims	4,163 45
Pay-rolls	467,562 79
Material	515,877 87
Making a total of	$1,040,861 31

The bondholders' security therefore instead of having the benefit of any net cash from the first Receivers, actually assumed the burden of and paid a deficit on that account

of $505,693.36 over and above all receipts from that source.

The expenditures for construction and new equipment during the receivership were inconsequential.

The claim is made that the foreclosing bondholders are chargeable with the interest paid during the receivership to mortgage bondholders senior to their own, and the sale fund in Court should therefore make good such payments.

The Supreme Court disposed of that contention in *St. Louis R. R.* v. *Cleveland R. R.*, 125 U. S., 668:

"It cannot be said that the application of earnings to "payment of interest on the first mortgage bonds is "chargeable to the holders of the second and third mort- "gage bonds. The latter alone are interested in the "fund for distribution. That fund in the sense of the "rule sought to be applied, cannot be said to have been "benefited by the payment to the other bondholders "from the gross earnings applicable to the payment of "rent. The equity of the petitioners, if in fact it ex- "ists, is against the holders of the first mortgage bonds, "who have actually received the money to which it "claims to be equitably entitled."

This authority was followed in *Cent. T. Co.* v. *E. Tenn., &c., R. R.*, 80 Fed., 624.

A large part of the interest on car leases and senior mortgages was paid by the first Receivers before the rail claim matured in October, 1892.

Interest payments could not therefore be a diversion as to it.

It was in addition insisted that the interest, rentals and dividends paid on the leased lines and equipment leases during such receivership was a diversion for the benefit of the foreclosing bondholders, and the sale proceeds should be chargeable with restoration of such sum.

It has already been shown that the user of the leased lines was not at the instance of the consolidated mortgage bondholders, and their security cannot be charged with any deficit resulting from compliance with the Court's orders in a suit not brought by them and when their debt was not in default.

These rental payments were all made under standing orders of the Court.

The appellee made no attempt to modify them or intercept the expenditures on that account, and must therefore be conclusively presumed to have accepted and approved them as being for the best interests of the whole trust estate including its own.

> *Cent. Trust Co.* v. *Wabash R. R.*, 34 Fed., 259.
> *Miltenberger* v. *Log. R. R.*, 30 *ibid.*, 332.
> *Kneeland* v. *Am. L. & T. Co.*, 136 U. S., 89.
> *Calhoun* v. *St. L. R. R.*, 14 Fed., 9.

Especially should this be the rule when the intervenor, in order to establish a claim for diversion, claims the benefit of the valuable leases as feeders largely aiding the gross earnings of the entire system.

The income of the controlled lines and the use of the equipment cannot equitably be availed of without accepting the burden of their rentals as an expense of current management, and not a loss to be made good out of the specific security of mortgagees who did not apply for the order and whose own current income was depleted several hundred thousand dollars to pay the arrearages of the first Receivers.

The controlling facts therefore are:

The foreclosing bondholders received no interest during either receivership.

There was little expense for improvement or new equipment.

The first receivers paid out of their own current income upon the company's labor and supply debts $97,-190.64 more than they received from the ante-receiver ship earnings.

The mortgagee Receivers paid out of their current income $505,693.36 on account of the debts of the first receivership over and above all credits from the latter's earnings.

The bondholders purchasers, in order to protect their security, paid into Court $455,144.50 to liquidate the deficit of the last Receivers' operating debts after application of all their earnings.

In addition, they paid on the final sale $1,000,000 Receivers' certificates and interest, issued as a paramount lien on the road to pay preferential labor and supply debts accruing in the six months prior to June, 1892. Upon such a showing, the bond creditors' security cannot be further oppressed by any additional assessment.

If the intervenor was in position to challenge the disbursement of revenue during the entire period of the general creditors' receivership the account as to diversion would approximately stand as follows:

Corp. earnings received................	$1,151,791 31
Construction done.....................	19,717 05
New equipment bought	74,733 28
	$1,246,341 24

Receivers paid, *ante* receivership, traffic debts, damage claims, rolls and vouchers	$1,237,196 22
The consol. bondholders have assumed and paid Receivers' certificates used to pay preferential debts.............	1,000,000 00
Total.........................	$2,237,196 22

The restoration out of receivership income and the corpus on any approved method of accounting exceeds nearly a million dollars what the law would in any theory recognize as diversion to the prejudice of a supply creditor.

Even if the equipment, sinking-fund and car-trust payments, and all construction expenditures on outside lines, should be added together and charged against the junior foreclosing bond-holders, the funds advanced by them as above stated would still exceed the total claimed diversion by several hundred thousand dollars.

Neither they or their security have ever inequitably received any money or expenditure to which they were not entitled and the appellee was.

Third. When a mortgaged Railroad Company purchases $125.000 worth of steel rails on an optional credit of ten months, subsequently extended for four months more, such claim is not a debt of the current income and cannot displace the mortgage lien, either as to income or sale proceeds.

The strong tendency of all the recent decisions in the

higher Courts has been to repudiate the theory of unlimited judicial discretion and to severely restrict the allowance of preference over recorded mortgages to a few exceptional classes of strict operating expenses, incurred on the faith of current payment and within a brief period before the mortgagee's application for a Receiver.

The Courts speak of the beneficiaries of this bounty as "a favored class," such as "materialmen and laborers "and some few others of similar nature."

> *Morgan* v. *Texas Cent. R.*, 137 U. S., 171.
>
> *F. L. & T. Co.* v. *Pine Bluff R. R.*, 21 S. W., 552.

Mr. Justice HARLAN restricted the claims fairly within the scope of such protection to "the current debts, the "daily and monthly expenses" which rely for payment on the daily and monthly earnings.

> *Thomas* v. *P. & R. I. R. R.*, 36 Fed., 808.

The test applied in *Kneeland* v. *Am. L. & T. Co.* 136 U. S., 89, to a claim of car rental for preference as a current operating expense, is conclusive here.

"No one is bound to sell to a railroad company or to "work for it, and whoever has dealings with a company "whose property is mortgaged must be assumed to have "dealt with it on the faith of its personal responsibility, "and not in expectation of subsequently displacing the "priority of the mortgage liens."

In *Huidekoper* v. *Loco. Works*, 99 U. S., 258, it was decided that the vendor of a locomotive "occupied the "position of a general creditor with no special equities "in its favor."

This principle applicable to these large transactions on long agreed credits was subsequently enforced in *Thomas* v. *Car Co.*, 149 U. S., 95:

"The case of a corporation for the manufacture and "sale of cars, dealing with a railroad company, whose "road is subject to a mortgage securing outstanding "bonds, is very different from that of workmen and em- "ployes, or of those who furnish from day to day sup- "plies necessary for the maintenance of the railroad. "Such a company must be regarded as contracting upon "the responsibility of the railroad company and not in "reliance upon the interposition of a Court of equity."

The affirmance by the Court of Appeals in this cause was in effect a reversal of its own ruling upon the intervention of the *Lack. Steel Co. in Bound* v. *S. C. R. R.*, 58 Fed., 473.

There a manufacturer had sold rails to a company, and after an agreed credit of about eight months and later a ten months' extension, claimed a preferential allowance against the *corpus* of the road on the ground that its debt was an "operating expense," and there had been a diversion of income.

It was decided that it had waived all claim upon current earnings by the credit given and renewed, which was in law a consent to use the current earnings for bond interest and otherwise.

The conclusion reached was:

"The debt of the Lackawanna Company was an or- "dinary merchandise debt, evidenced by notes which "were renewed from time to time. It had no stronger "equity or claim upon the earnings than had those who "had advanced money to pay the interest upon the "bonds.

" The claim is quite different from those ordinary and
" necessary current expenses of operating the railroad
" contracted but a short time before the receivership,
" and which, by the sudden action of the Court, are left
" unpaid.

Enforcing the doctrine ruled in *Thomas* v. *Car Co.*, the Circuit Court of Appeals, in the 7th and 8th Circuits have excluded car rentals from preference as debts of the current income.

> *Mather Stock Co.* v. *Anderson*, 76 Fed., 164.
>
> *P. R. Car Co.* v. *A. L. & T. Co.*, 84 *ib.*, 18.

In *Lack., I. & S. Co.* v. *F. L. & T. Co.*, 79 Fed., 202, the Circuit Court of Appeals for the 5th Circuit followed the ruling in *Bound* v. *S. C. Ry.*, and held that a large claim for steel rails sold on several months credit was not an operating supply claim entitled to preferential payment out of the receiver's income or the sale proceeds under a foreclosing mortgage.

The claims allowed preference in *Burnham* v. *Bowen*, 111 U. S., 776, and *Va. Coal Co.* v. *Cent. Geo. R.*, 170 U. S., 359, were for coal, which is an undoubted and necessary operating supply.

No original or extended credit was contracted for, but reliance for payment was had upon the current income.

4,200 tons of heavy rails is sufficient to re-lay about forty miles of road. It is not like coal—a current supply for moving trains which is consumed in the operation. The new rails take the place of the lighter rail already in the track, and constitute by such substitution, a permanent part of the mortgage security.

It has always been contended by the appellee that steel rails bought by the receivers was not an operating supply, but such a distinct betterment as to constitute a diversion of the income.

The rails sold by the appellee were not "current supplies" or "necessary to enable the road to be operated as a continuing business," within the meaning of those terms in the last ruling of this court, but purchased to be permanently annexed to the road bed of a mortgaged railroad as an improvement thereto.

It was not a month to month supply debt in the ordinary course of the railroad's operations, but an extraordinary expense incurred solely to permanently improve the fixed mortgage security.

The appellee also fails on the other test of a preferential claim as defined by this court in *Va. Coal Co.* v. *Cent. of Geo. Ry.*

To award a preference it is indispensable that the supplies should not be purchased simply on the personal credit of the railroad company, "but upon the tacit or express understanding that the current earnings would be appropriated for the payment of the debt."

By agreed credit and extensions the appellee carried its debt on the mere personal responsibility of the railroad company, and payment of interest from July, 1891, to October, 1892.

By express contract it absolutely released any claim for payment out of the current earnings of the system during that period, and left the railroad company a free hand to dispose of its income at will, without any liability to ever account for such disbursements.

Whatever other supply creditors might assert, this par-

ticular rail creditor has forever precluded itself from claiming that a dollar of the earnings prior to October, 1892, should have been used for the payment of its claim. The agreed credit had not expired, its debt was not due and it had expressly contracted that it need not be paid out of current income.

It was bound to take notice that during that period three interest payments would mature upon the consolidated mortgage, October, 1891, and April and October 1892.

Its conduct and contract must be held to be an express consent to the use of such current earnings for the payment of maturing coupons and all other *bona fide* corporate debts.

Having abandoned all resort to the current income, it fails in an essential condition and loses all claim to preference.

Its contract and its subsequent voluntary extension of credit for four months is conclusive that it sold the rails to a railroad company "on the faith of its personal responsibility and not in the expectation of displacing the priority of the mortgage liens" but with an express release of all claim on current income.

The principle enforced in *Kneeland* v. *Am. Loan Co.*, 136 U. S., 89, forbids that the mortgagees' rights shall be postponed to any such unsecured indebtedness.

Fourth. As the court adjudged that the rail creditor had a statutory lien under the laws of Virginia upon the railroad and its earnings which was subordinate to a large portion of the consolidated mortgage debt, it was error in the same decree to enforce an equitable charge superior to the entire mortgage debt:

The decree in one clause adjudges that, according to the state law, the appellee's debt is junior to $1,621,000 of the mortgage debt, which is sufficient in amount, as will be shown, to absorb all the net fund distributable to creditors. In the second clause it decrees that the entire rail claim "is entitled to priority of payment out of the fund "resulting from the sale of the mortgaged property" over *all* the bonds secured by the foreclosed mortgage.

The situation is unique. It stands in judgment that under the statutes of the state where the mortgaged property is situate, a large part of the mortgage debt outranks the lien of the appellee on road and earnings.

It is, however, adjudged that by the law of the court the rail claim is paramount to all the bonds.

Thereby a valid local statute which by the decree legislates priority to a part of the bonded debt is in effect judicially repealed, an important clause of the decree is nullified, and full payment is ordered of an actually adjudged second lien in preference to one that is admittedly first according to the law of the Commonwealth.

It is submitted, with entire respect to the Circuit

Court, that its decree and order of payment is an unwarrantable extension and misapplication of what was decided in *Fosdick* v. *Schall.*

That case involved consideration in respect to the discretionary power of an equity court, *invoked by a railway mortgagee*, over the currrent income during the receivership, *in the absence of State legislation regulating the subject.*

This appeal involves no such question. Here the State has enacted statutes declaring with precision what claims shall constitute liens on railroads, their franchises and *earnings*, and under what conditions they arise and can be asserted and over what mortgages such statutory claims shall have priority. The appellee pleaded and claimed rights under this statute.

It is of the essence of the sovereignty of each State that its Legislature has plenary powers to establish the conditions upon which domestic corporations may exercise their franchises, and to enact the only regulations by which real estate within the territorial jurisdiction can be aliened or encumbered.

Clearly, it is within the power of each State to legislate as to what particular claims shall constitute specific liens upon the property, franchises and earnings of its own railroads, and also to establish the precise methods by which such liens must be perfected and enforced, and what rank they shall be allowed.

Whenever a State, in the exercise of its undoubted legislative power, has enacted statutory regulations covering the whole subject-matter of liens on railroads and their earnings, and the manner in which they must be created and enforced, and the priority of such claims in

respect of mortgage or other liens, there can be no occasion for any exercise of judicial discretion over the same subject.

Whatever the State law makes liens on property and earnings are such, and must be paid in their statutory rank if perfected and asserted in compliance with the statutory conditions. Whatever claim is not within the statutory description, or is not made effective by the statutory methods, is not a recognizable or enforceable lien, and no Court, State or Federal, possesses any jurisdiction, on some supposed principle of general equity to ignore and repeal a valid State law whereby the property rights of creditors have been absolutely determined.

If the State law fixes liens and priorities on railroads and their income, there can be no others born of mere judicial discretion.

The expression of one is the exclusion of all others.

Such statutes regulating liens on realty constitute rules of property and exclude all judicial action in disregard thereof.

Brine v. *Ins. Co.*, 96 U. S., 635.

The sole judicial function is to administer the State law on the subject of railroad liens and priorities as it exists on the statute book, and proceed no further.

In *Trust Co.* v. *K. C. W. & N. R. R.*, 53 Fed., 191, it was said:

"It seems probable that the Courts will not have to " deal with the question on general principles of equity " much longer. Some of the States have already passed " acts giving all obligations incurred in the construction

"and operation of a railroad priority over mortgages and "similar statutes will probably soon be passed in other "States, unless the practice and decisions of their Courts "shall render them unnecessary."

The very point has been decided by the Supreme Court of Georgia:

"It seems to us plain that the object of the Code "would be frustrated and virtually defeated if a con- "tractor who has secured a lien, but failed to enforce "it in the manner prescribed, can abandon that lien and "*fall back upon an alleged equitable lien involved in the* "*very same state of facts out of which his legal lien* "*arose, and thereby postpone or defeat a mortgage upon* "*the railroad, duly recorded and foreclosed.*"

"We entertain no doubt that the law contemplates "that a contractor to whom it gives a legal lien upon a "railroad, and who has nothing to do in order to take "the benefit of it but to enforce it in the way pre- "scribed, *shall have no other lien either in addition to* "*it or as a substitute for it.*

"But with that system, and the relation to it which "this contractor occupies, we deem it perfectly clear "that he is restricted to his statutory lien, and must en- "force that or none at all."

F. L. & T. Co. v. *Candler*, 18 S. E., 540.

The decree in terms awards the appellee the statutory lien which it pleaded. The Court also construed the Code, and on the basis of that interpretation fixed its priority as that of a second lien junior to a part of the mortgage debt.

No exceptions were ever filed to the master's report on

this point, and no cross-error was assigned on this clause of the decree.

Having thus read the lien law and its results into the rail purchase, upon what possible principle of law can the Court then thrust the legislation out of the transaction, reject the mortgage priorities established by the statute and create and arbitrarily enforce an inconsistent, so-called equitable priority?

Stated in plain words, this is a practical repeal of legislation and the substitution of a scheme of distributing a fund, which, according to the judicial conception, is more consonant with equity than that provided by the discarded statute.

The all-sufficient answer is that the courts have no power whatever over the subject except to enforce the law as it exists.

" Every departure from the clear language of a stat-
" ute is, in effect, an assumption of legislative powers
" by the Court."

Brewer v. *Blougher*, 14 Pet., 178.

If the rail claim of petitioner was primarily of such nature that it could have been lawfully perfected as a statute lien, but by the act it is subordinated to all or any part of the mortgage debt, it is submitted that it is not within judicial power to decree to the identical claim the very priority of payment which the statute expressly disallows.

Mere equitable discretion cannot be properly invoked to accomplish a priority of payment which positive legislation forbids.

Virginia has enacted laws covering the whole subject

of the creation, perfecting and enforcement of supply liens upon railroads *and their income.* It has established their rank and priority in respect to mortgages on the same property.

The function of an equity court in the enforcement of a right exclusively of statutory origin arises out of and is restricted to the specific legislation.

" Whenever the rights of parties are clearly defined " and established by law, equity has no power to change " or unsettle those rights or that situation, but in all " such instances the maxim '*Equitas sequitur legem*' is " strictly applicable."

Magniac v. *Thomson*, 15 How., 281.
Hodges v. *Dixon Co.*, 150 U. S., 182.
Thompson v. *Allen Co.*, 115 *ibid.*, 555.

The Court's decree has in express terms adjudged that under and by the State law invoked by appellee a portion of the mortgage debt is entitled to priority over the appellee's claim.

Certainly the opinion in *Fosdick* v. *Schall* furnishes no precedent for an equity court to assume and exercise the discretionary function of repealing State laws and overturning admitted statutory rights and priorities which have been in the very litigation expressly adjudged to exist.

" Stripped of its verbiage this doctrine is that because " the Court has control of a fund brought to it for dis- " tribution it may give it away as it pleases. If it means " that, the power of the Court would indeed reach the " case of these petitioners; but it would make the judge " in equity an arbitrary tyrant, and none the less so be-

"cause the tyranny disguised itself as a judicial com-
"mand."

Mat. of Atty.-Gen. v. *N. Am. Ins.*, 91 N. Y., 64.

Appellant denies the existence of any judicial power to substitute and enforce its own discretionary priorities in lieu of those established by law.

FIFTH. As the decree adjudged that $1,621,000 of the consolidated bonds had an express statutory lien prior to the claim of appellee, the Court had no rightful power to deprive them of that adjudged priority by ordering the payment of the rail claim in full out of a fund insufficient to pay such prior bonds.

Having actually decreed such bond priority in obedience to an express law establishing a rule of property, all judicial action in disregard thereof was prohibited.

Brine v. *Ins. Co.*, 96 U. S., 635.

By one clause of the affirmed decree the intervenor was adjudged to be entitled only to come upon the surplus of the net sale proceeds after full satisfaction of the prior $1,621,000 bonds and interest.

The record demonstrates there is no surplus.

The sale was for $2,020,000, including the Washington property, leaseholds in roads outside the State, $1,351,000 debenture bonds and $2,844,000 first mortgage bonds on other railroads.

The Code did not give and the Court did not award,

the least semblance of lien to appellee upon any of these outside properties and securities. They were undoubtedly valuable and contributed largely to the fund in court.

The debenture bonds were secured by a mortgage prior to the consolidated.

Even without any recoupment on that account, the entire net fund is still insufficient to discharge the principal and accrued interest of the $1,621,000 bonds adjudged to be first entitled to payment.

After deducting from the gross bid $75,000 cash paid the Masters for costs and expenses, and $455,144.50 paid in to discharge the deficit of Receivers' operating debts—making a total credit on the bid of $530,144.50—there would remain to be distributed under the decree on mortgage and other liens only a net surplus of $1,499,855.50 of the unit bid for the railroad and all other property. The amount due for principal and interest of the admittedly preferred $1,621,000 consolidated bonds was at time of decree $1,800,000.

This, also, leaves out of the reckoning any allowance for the $1,000,000 Receivers' certificates which were by decree constituted a paramount lien upon the railroad prior to all bonds and claims and which were also paid by the purchaser. On the accounting between the consolidated bonds adjudged to hold a superior rank and the statutory rail lien, the former were under no obligation to pay off the certificates at their cost and thereby relieve the appellee as a gratuity.

It is clear upon every test afforded by the undisputed figures that, upon the adjudication of statutory lien, the fund on which the rail creditor was decreed a postponed

lien was inadequate to pay the adjudged first rank bond claim of $1,621,000 and interest.

Under such circumstances the peremptory order to pay a second charge out of a fund not sufficient to pay an adjudged first lien was an unjustifiable abrogation of the very priority which had been finally decreed as a statutory right to a moiety of the bonds.

SIXTH. The affirmed decree erroneously severed the single lien of a railway mortgage and separated the bond issue into preferred and deferred obligations.

Such a mortgage takes rank as of its record.

This principle of absolute equality of all the bonds issued under the trust deed is of the very essence of such a security and cannot be broken in upon by any judicial construction, subsequent contracts, acts of the parties or legislation.

Pennock v. *Coe*, 23 How., 117.
Jackson v. *Ludeling*, 21 Wall., 616.
Stanton v. *A. & C. R. R.*, 2 Woods, 523.
Ames v. *Railroad*, *ibid.*, 206.
State v. *Cobb*, 64 Ala., 127.
Barry v. *M. K. & T. R. R.*, 34 Fed., 829.

Such a basis of credit would be absolutely valueless if it was not held to be what it recites, a common security for the ratable benefit of a class of beneficiaries equally entitled to share therein.

The consolidated mortgage in the first article declares: " this mortgage shall be a security for the whole or any

" part of the amount of the bonds authorized to be issued
" as herein aforesaid and all bonds issued hereunder,
" shall be equally secured hereby without regard to the
" time when the same may be issued." (Record, 63.)

In a recent Pennsylvania case, the non-severable nature of such security was rigidly enforced.

" The bonded debt is a unit, so far as the duties and
" powers are concerned. He must regard the bondhold-
" ers as a class, and not as individuals.

" It has been held to be a presumption of law that all
" the bonds were issued at the same time which were
" secured by the same mortgage, and that the fact that
" they were numbered consecutively gave no priority to
" any and interfered in no manner with the equality of
" their holders on distribution. That distribution must
" be made *pro rata* is well settled.

" What may be realized by such proceeding belongs
" to the whole class and must be distributed *pro rata*."

Com. v. *S. & D. R. R.*, 122 Penn. S., 306.

The Virginia Code regulating liens on railroads and their earnings, provides that no mortgage deed of trust, etc., *executed after* the taking effect of such code on May 1, 1888, shall defeat or take precedence over said lien.

Va. Code, Sec. 2,485.

Newgass v. *A. & D. R. R.* 56 Fed., 676.

To construe the section to give priority to so many of the mortgage bonds as were actually issued prior to the code is not only not warranted by the text of the act, but is in plain disregard of its express words; is at war with established legal principles; would be destructive of this class of negotiable securities; is incapable of practical

enforcement and if adcpted, would render the act plainly unconstitutional.

It is an elementary canon of construction that it is not allowable to interpret that which has no need of interpretation.

"When the words of a statute have a definite and "precise meaning, such meaning cannot be extended "or restricted under the guise or pretext of interpre- "tation."

The act does not even mention bonds or remotely allude to the date of their issue as constituting any test of priority of the supply lien. The section established priorities as between certain written instruments required to be recorded, such as mortgages, deeds of trust and conveyances on the one hand, and recorded notices of labor and supply liens on the other. The section as interpreted only deals with and postpones "mortgages, deeds of trusts, sales, conveyances, etc., "executed since May 1, 1888." Over such subsequently executed mortgages and other deeds and none others, the newly created supply lien is to take precedence.

The words, both in their ordinary and legal significance, are susceptible of but one meaning. The test of priority is not the date of the issue of bonds or of advances under mortgages, but is determined solely by the execution of the mortgage or trust deed itself. The statute does not attempt to displace, postpone or to any extent impair, or even deal with, mortgages executed before May 1, 1888, any more than to defeat absolute conveyances executed prior to that date.

The words of the section are express and unambiguous and must be accepted as they stand. The mort-

gage here was executed and recorded in 1886, long before May 1, 1888, when the Code took effect, and therefore, is not in any way within the purview of the act. Any mortgage executed prior to the adoption of the Code continues to stand upon its vested rights, and must as to all the debt it secures "defeat and take "precedence" over the supply lien.

The only statutory test of preference is the execution of the mortgage, a single fact to be settled by the public records. The dates of different bond sales can only be laboriously ascertained by private investigation and testimony to determine the priorities.

The lien law would without doubt be read into all mortgages executed after it became operative, as all parties would then be chargeable with knowledge of its provisions, and would be conclusively presumed to have contracted their obligations with submission to its terms.

For like reason the lien statute, restricted by its own words to mortgages executed after it took effect, cannot be incorporated into, postpone, or split up a mortgage executed and recorded over a year and a half before there was any law under which a material creditor could under any circumstances obtain a lien upon a railroad.

The Code cannot be construed so that a single debt secured by a single mortgage is severable. This result is not warranted by the words of the statute, is inconsistent with settled rules of law, would be wholly impracticable in method and would greatly impair the marketable value of such securities.

The Code in plain words deals with a mortgage as a single written security, and not with the dates when the bonds were issued thereunder. One executed before the

Code wholly defeats and takes precedence of the material lien for the entire secured debt, no matter when the bonds were issued. If executed afterwards, the mortgage and the whole debt thereby secured is postponed to all valid material liens. There is no warrant in the law for any severance of the mortgage debt and the preference of a portion of the bonds over the supply creditor and then award the latter's claim a priority over the remaining bonds.

The Code does not expressly or by any fair intendment operate to confiscate the bonds subsequently sold under a mortgage security executed prior to the lien law. It would thus result that a moiety of the mortgage debt would have the security of a first lien, the supply creditors the second and the balance of the mortgage debt would be reduced to the third rank. Neither reason or authority justify any such dealing with the single lien of a mortgage when its priority is based upon and determined by its execution and record.

The *habendum* clause in the mortgage runs to the trustee "for the equal *pro rata* benefit and security of "all the holders of said bonds secured hereby, without "any preference or priority by reason of priority in time "of issue thereof."

The provision of the mortgage regulating the distribution of the proceeds of sale declares that they shall be applied to the ratable payment of the interest and principal of the bonds "without preference, priority or dis-"tinction of one bond over another." (Record 71.)

It is, therefore, legally impossible under the mortgage foreclosed that there can be two classes of bondholders, one holding a lien as of October, 1886, and the other

an inferior lien later than May, 1888, and postponed to any and all ranking statutory labor and supply liens.

Claflin v. *Railroad Co.*, 4 Hughes, 12, determined the precise question. Certain first mortgage bonds had been retired by the railroad company and were reissued for value after a series of second mortgage bonds had been negotiated. The latter's claim of priority over the reissued firsts was rejected.

Chief Justice WAITE said, that such bonds were a kind of public funds.

" When in the hands of the company their lien under " the mortgage was suspended, but the moment they " were out in the usual course of business they again " took effect *as of the time when the mortgage was* " *given*. Any other rule than this would materially im- " pair the marketable value of this class of instruments " and tend to defeat the very object of their execution. " The whole issue of such bonds must be treated as of " the date of the mortgage without regard to the time " they were actually put out, unless the contrary is clearly " expressed."

The doctrine of the Newgass opinion and of the decree under appeal that all buyers of Virginia railroad bonds after May 1, 1888, were charged with notice that supply creditors were entitled to priority of payment over bonds thereafter issued under mortgages executed and recorded before the Code took effect, would revolutionize the whole law of negotiable securities.

In *Cent. Trust Co.* v. *Lou., &c. R. R.*, 70 Fed., 282, the court upon an elaborate discussion of the precedents refused to follow the ruling in the Newgass case because it was opposed to the weight of authority.

By the settled laws regulating negotiable securities no such constructive notice or duty of inquiry as to the date of the original issue of an obligation is cast upon the purchaser who buys bonds in the open market.

In such event the bonds are, whenever bought, entitled by an express and continuing valid covenant of the mortgage to an equal share of whatever security and priority is afforded by the recorded mortgage to any and all other previously issued bonds.

There is no evidence or finding that the whole or any part of the postponed $2,906,000 consolidated bonds issued after May 1, 1888, are now held by those who obtained them directly from the mortgagor.

On what principle can the doctrine of the Newgass case be applied to postpone the innocent holders of such securities bought in open market?

Applying the doctrine to this controversy, $1,621,000 of the mortgage bonds carried a lien as of October, 1886, and were superior to and should be fully paid out of the proceeds of the mortgage property before any statutory liens for supplies. The other $2,906,000 bonds, with the same date and recitals, instead of enjoying an exactly similar priority with others of the issue, as the mortgage expressly covenants, solely because they were not originally sold by the mortgagor until after May 1, 1888, are forever reduced to a third lien and postponed to an indefinite and unlimited statutory liability for material debts which can be perfected into second liens.

Obviously, if the enactment of a lien law works such a result upon the bonded issue of a prior mortgage, the $1,621,000 bonds issued before the lien law was enacted would be worth far more per bond in the market on their

merits as first lien bonds than the others, which though certified under the same indenture, as entitled to an exactly similar security, were not actually issued for value until after the lien law and are for that reason reduced to only third lien bonds. How could any intending purchaser of such securities in the open market distinguish between the first and third lien bonds of the same series or determine from the face of a bond the date of its actual issue or that its recitals were false and it was in law not entitled to a lien until after all material claims had first been satisfied?

What knowledge would they have or could they obtain that any particular $2,906,000 bonds had in fact been issued by the corporation after the passage of such lien law? While those who made such original purchases direct from the mortgagor might have such notice, there is no known principle of the law merchant which will charge either first or remote purchasers from such original takers with any constructive knowledge of the date of the actual first issues of such bonds.

The serial numbers on the bonds furnish no evidence of the time of issue. That is no part of the obligation, but is an incidental and wholly unessential characteristic.

Elizabeth v. *Force*, 29 N. J. Eq., 587.

In a somewhat similar controversy a contractor attempted to charge the duty of inquiry on the part of bondholders and to establish guilty notice because of his actual work on the railroad, and thereby postpone mortgage bonds not in fact issued by the company until after he had begun the construction for which he claimed a senior lien. His contention was that when his work began no money had been advanced under the mortgage security, and it did not in law exist until the bonds were issued.

His claim of priority was refused. The court held:

"It would be out of the question to ascertain the "state of the record or of the company's affairs each "time a bond was about to be sold."

"If this were made the duty of purchasers, it would "prevent the sale of such securities altogether, or at "least confine their purchase to such large concerns as "could buy in bulk after due and careful inquiry. Even "then the facts would be open to doubt at every subse- "quent sale. Thus their value would be entirely re- "duced. For these and similar reasons, the whole issue "of such bonds must be treated as of the date of the "mortgage, without regard to the time when they were "actually put out, unless the contrary is clearly ex- "pressed."

Reed's Appeal, 122 Penn. S., 574.

As it has been strongly put:

"If the purchaser of a bond in New York, in Amster- "dam or London is bound to inquire whether the bond "in fact was executed by the company contemporaneously "with the execution of the mortgage, or whether, before "the signing or the negotiating of the bonds, liens of "laborers or materialmen may not have attached to the "road, it is apparent that the value of these securities "would be much depreciated and all industries which "depend upon the raising of means through negotiation "would be paralyzed."

The doctrine of constructive notice or the duty of making any inquiry whatever beyond the face of the instrument bought has no place in the law protecting the purchasers of negotiable securities.

The law merchant recognizes no principle which would in practice destroy the negotiability of such securities.

Simons v. *Goodman*, 20 How., 343.

When it is attempted to effectuate by decree the theory of severance of a mortgage debt into distinct classes with variant liens and priorities, its unsoundness and danger become apparent.

It would be a revolutionary innovation on equity procedure in foreclosure suits to adjudge the liens of any of the mortgage creditors from any date or event other than its original execution and registration.

The sale proceeds would no longer enure ratably to the bondholders as a class; but, in order to finally determine what particular individuals were respectively the holders of the preferred $1,621,000 or of the postponed $2,906,000 bonds, so as to make uneven distribution, the court would be forced to investigate the origin of each of the 4,527 bonds and determine whether it was issued before or after May 1, 1888.

The remote innocent holders of the latter class would suffer a confiscation of their liens solely because they would be chargeable with constructive notice that the bonds dated and equally secured by mortgage of October, 1886, and bought by them in open market without further notice, were, in fact, not originally issued until after May 1, 1888.

If the railroad company in July, 1887, had executed and recorded a mortgage for $2,500,000 junior to the consolidated and had issued all the bonds thereunder prior to the adoption of the code, it stands fully confessed that such mortgage of 1887 would as to its whole debt be prior in lien to the intervenor's claim under the

code of 1888. It is equally incontestible on general legal principles and the authorities cited that, as between the two mortgages of 1886 and 1887, all the bonds issued under the consolidated mortgage would have a priority over the latter, notwithstanding the fact that some or even all of the bonds secured by the consolidated mortgage were not actually issued for value until after the junior mortgage had become a recorded lien on the same premises.

How could a foreclosure decree be possibly framed on the theory of the recovery below, which would as between the mortgage and material liens devote the proceeds of the sale, first to the full payment of all the consolidated bonds, whenever issued, before any payment on the supposed junior mortgage of July, 1887, and yet should at the same time adjudge that the intervenor's lien for rails was inferior in rank to the whole debt secured by the junior mortgage of 1887, but superior to a part of the bonded debt under the mortgage of 1886?

This would be the inevitable result of the doctrine when applied. The existence of any such inconsistent priorities is a legal paradox, and demonstrates that the theory of severance and priority is unsound and impracticable.

By the decree under appeal the mortgage is severed and some of the supposed equal beneficiaries in a common security would, out of the proceeds, if sufficient, realize par and interest on their bonds, and the remaining *cestui que trusts* wonld be remitted to the surplus, if any, remaining after satisfaction of statutory liens.

On what possible principle could equity thus subvert

the whole scheme of a mortgage which expressly covenants as one of its essential and continuing trusts that all bonds of the issue shall be equal as to security and payment, and that any proceeds of sale shall be applied to their ratable payment "without preference, priority or "distinction of one bond over another"?

There were 4,527 consolidated bonds issued. Each bond was necessarily entitled to draw a four thousand five hundred and twenty-seventh part of the net sale proceeds, and no more.

How could equity, called upon to enforce such common trust, practically destroy the equal distributive rights of 2,906 bonds and unlawfully swell the aliquot shares of the favored remainder by distributing the entire proceeds allotted to the recorded mortgage lien among only 1,621 bonds?

If the lien section of the Code is applied to mortgages executed before its passage with any such interpretation or result, it would materially impair the obligation of such existing contracts, and to that extent be unconstitutional and void.

This proposition needs no elaboration. The effect of the Code of 1888 as thus expounded would operate directly and injuriously upon the covenants, liens and obligations of the prior mortgage of 1886, and materially injure the negotiability and value of all the bonds.

These rights, subsequent legislation cannot touch.

Knapp v. *Railroad*, 20 Wall., 117.
Fletcher v. *R. & B. R. R.*, 39 Vt., 633.
Murray v. *Gibson*, 15 How., 421.
Carrol v. *Carrol*, 16 *ibid.*, 275.

On the constitutional test the anterior mortgage lien must remain inviolate, and the validity of the Code provision can only be upheld by restricting it rigidly to its precise terms and construe it as applicable, not to bond issues at all, but only to " mortgages executed " after its taking effect, and none others

Donalry v. *Clapp*, 12 Cush., 440.
Parker v. *Mass. R. R.*, 115 Mass., 580.
McConneaughey v. *Bogardus*, 106 Ill., 321.

The consolidated mortgage of 1886 was to a large extent designed to be a refunding instrument, and not alone a means of borrowing fresh money (Record, 56). The consolidated bonds issued thereunder were to be mainly used to take up, refund and exchange the mortgagors' first-lien bonds and second-lien debenture bonds, and for acquisition of not to exceed $15,000 per mile of first-mortgage bonds of other roads, to be deposited as part of the mortgage security and for new equipment not to exceed $2,500 per mile of road.

In the first paragraph of the schedule of trusts (Record, 68) it is expressly provided that all bonds so exchanged or acquired shall be retained and held by the trustee without cancellation, and "without any release, relin-"quishment or impairment of the lien or security of the "said several mortgage deeds of trust under which the "exchanged bonds have been issued," etc.

The decree of foreclosure adjudges (Record, 269) that $632,000 consolidated bonds were issued in exchange for debenture bonds; $719,000 for debenture bond coupons and scrip; $350,000 for new equipment; $2,826,200 in exchange for $2,844,000 first mortgage bonds of eleven different railroad companies recited in the decree and

constituting a part of the mortgage security represented by the sale proceeds in the registry.

Whatever the supply lien on the physical road, the $2,906,000 bonds issued after May, 1888, could not be lawfully deprived by the rail creditor of this specially reserved lien of the $1,451,100 deposited debenture bonds and the lien of the mortgage *of 1882* securing them, or of their lien upon the deposited $2,844,000 first-mortgage bonds of other companies. Neither of these two classes of security constituted "property used in operating the railroad." Consequently, appellee had no possible statutory lien upon those parts of the security included in the consolidated mortgage. They were sold and contributed to the fund in court. Clearly the third paragraph of the decree that the debt of the appellee, "by reason of the "statutes of Virginia, is entitled to priority of payment "out of the fund resulting from the sale of the mort-"gaged property" over the $2,906,000 bonds cannot be sustained either on the lien law or on any theory of equity.

SEVENTH. The severance of the mortgage debt adjudged by the decree under appeal is a collateral impeachment and unlawful annulment of material provisions in the final decree of foreclosure under which the proceeds of sale were brought into court, and impairs the rights of the purchaser.

The foreclosure decree was rendered April 13, 1894. It has never been amended. At the close of the term

when entered it passed beyond the power of the court. The appellee was a defendant in the cause. The recitals of the decree therefore bind and conclude it as to all matters adjudged. It decreed that such mortgage was issued to secure all bonds issued thereunder "*without preference or priority and equally and ratably*" (Record, 265); *that 4,527 consolidated bonds were outstanding in the hands of bona fide holders for value, and that all such bonds and coupons "are entitled to the security of said consolidated mortgage*" (Record, 273).

All consolidated bonds and coupons were decreed to be receivable in discharge of the bid without any discrimination or difference in value dependent on the varying dates of their original issue (Record, 279). The fund arising from the sale after payment of costs was ordered to be distributed first to "*the payment ratably of the interest due and unpaid upon the consolidated bonds and thereafter upon the principal of such bonds* (Record, 281). The only liens which the court reserved the power to allow against the property or the purchaser assumed to pay, were those decided to be prior in lien or superior in equity to the mortgage foreclosed.

The Court is without power to vary or enlarge the obligation of the purchaser.

Davis v. *Duncan*, 19 Fed., 477.
C. & O. R. Ry. v. *McCammon*, 61 *ibid.*, 772.

These provisions of the final decree constitute a conclusive adjudication as to the unity of the entire mortgage debt, that each consolidated bond is of equal value and entitled to exactly the same distributive share of the

mortgage security and sale proceeds with every other bond of the issue.

Bound v. *S. C. R. R.*, 71 Fed.; 53.

The sale proceeds were realized under the execution of this decree, which adjudged the inseparable unity of the mortgage debt and the equal ratable right of every bond of the issue to the same security and satisfaction.

The court has no judicial power after such decree, sale and conveyance, to subvert the underlying principle of the decree, and in an order upon an intervention, in effect reverse and re-decree the adjudged liens and priorities of the bondholders, and order that a certain portion are to be preferred in payment out of the sale proceeds and the remaining bonds are to be postponed to subsequent debts.

The proceeds must be distributed on the basis of the decree under which they arose.

The only reserved equity is to allow claims which outrank the mortgage considered as a unit. The Court retained no power to vacate or alter the adjudged equality of all the consolidated bonds upon the proceeds of sale or to make any allowance in preference to a part of the bonded debt.

The practical execution of the third paragraph of the decree of the intervenor would require the payment of interest in full on the $1,621,000 preferred bonds, and then the full payment of all their principal, leaving the interest and principal of the $2,906,000 postponed bonds to come against any surplus remaining after appellee's claim had been fully paidas a second lien.

This would annihilate the equal rights of distribution adjudged by the final sale decree to every bond of the class, and is obviously beyond the judicial power.

Upon the foregoing grounds the appellant prays reversal.

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No. ~~39~~ 8

Sup. Brf. of Crawford & Smith for Appt.

Supreme Court of the United States.

Filed Nov. 7, 1898.

October Term, 1898.

Certiorari to the Circuit Court of Appeals for the Fourth Circuit.

SOUTHERN RAILWAY COMPANY,
Appellant,

vs.

CARNEGIE STEEL COMPANY, LIMITED,
Appellee.

Supplemental Brief for Appellant.

HENRY CRAWFORD,
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Supreme Court of the United States.

SOUTHERN RAILWAY COMPANY, Appellant, vs. CARNEGIE STEEL COMPANY, LIMITED, Appellee.	No. 39.

CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

Supplemental Brief for Appellant.

1. It was insisted at the bar, as well as in the appellee's brief, that the rail claim should in equity be charged against the sale proceeds because the order granted on June 28, 1892, directed the Receivers to apply incoming earnings to the payment of accruing rentals on leased roads and equipment.

Authorities were cited to support the proposition that claims of this sort are not entitled to priority in equity, and therefore constitute diversion.

The decisions invoked do not to any degree whatever sustain the contention of the unsecured creditor.

In Quincy Co. vs. Humphreys, 145 U. S., 82, it was held that the mere appointment of Receivers for a railroad system and the temporary user of a leased

line by the Court's officers did not constitute them assignees of the term and charge the rental upon the foreclosing mortgagee.

Kneeland vs. Loan and Trust Co., 136 U. S., 89, and Thomas vs. West. Car Co., 149 U. S., 95, decided that the rental of cars accrued before a receivership was an ordinary unsecured debt not entitled to preference in payment out of the income of a receivership.

The appellees' debt rested upon the personal credit of the railroad company. By the six months' limitation of the original order, it had no claim whatever to be paid out of the Court's income. The car and road rentals ordered to be paid were not corporate debts accrued before suit, but the reasonable current expenses of the receivership necessarily incurred in the management of the property taken into judicial custody and of course to be paid as primary operating debts of the Court itself.

It is not necessary to cite the repeated decisions of this Court which enforce this principle.

The order of June 28, 1892, in respect of the direction to pay accruing car trusts and rentals was a mere reaffirmance of like terms in the original order of appointment and did not constitute any original or variant appropriation of receivership income.

The Court reserved the power to modify or set aside this order upon the application of any party in interest. If in law the appellee was entitled to be paid out of such income it should have asked to be relieved against the inequitable diversion. It is concluded by its acquiescence.

The charge is made that " the trustee for the bond-
" holders joined in procuring this order directing the
" Receivers to divert the earnings generally from their

"natural use in paying the current expenses of the "company," &c.

The only warrant for this statement is that the trustee, although not a party to the suit, was served with a notice of the application for the issue of Receiver's certificates which would postpone its mortgage liens.

The consolidated bonds subsequently foreclosed had no possible claim upon the current income of the first receivership or any color of right to object to the use thereof for the payment of car trusts or rentals due for the use of property by the Court.

Their interest had been paid and there was no existing breach of condition of their mortgage to give them any right to share in the current earnings or to dictate how they should be applied by the Court.

The fact that the consolidated bondholders did not actively resist an order applying income upon which they had no claim does not create an equity for an unsecured creditor, to be first paid out of the mortgage security.

The charge is many times repeated that the car and rental payments were made "merely for the purpose "of keeping the property together for the benefit of "the bondholders."

The record furnishes no justification for this assertion.

It shows the system was not kept together. Prior to the foreclosure decree many leased or operated divisions were dropped.

Out of the twenty-six railways constituting the system taken into custody under the Clyde bill, the consolidated mortgage was only a lien on nine leasehold estates (Record, 65-67, 266-268).

Of these the leases of the Columbia and Greenville,

Charlotte, Columbia and Augusta, and York River roads were not assumed by the purchasers (Record, 291).

The table C (Record, 432) shows that the Clyde Receivers were operating and paying rentals upon 25 leased lines.

Exhibit B (Record, 431) shows that the foreclosure receivers only operated the few roads specifically covered by the consolidated mortgage and in fact only paid contract rental upon five lines.

Of these the North Carolina, Virginia Midland and Atlanta and Charlotte Air Line were indispensable to to any profitable working of the Richmond and Danville Railroad.

Deprived of their control the main stem would have been reduced to a mere local and non-remunerative road between Richmond and Danville.

Under the circumstances disclosed by the record the rail creditor had no equity whatever to demand that its claim should be paid to the exclusion of the rental of lines essential to the production of any net revenue, or that the mortgagee's estate, having been already subjected to $1,000,000 liability for preference claims, should be required to pay another large sum for rails sold the company on long credit because the Court paid out ncome to which the mortgagee had no claim upon road rentals and car trusts instead of unsecured debts.

2. It is urged that the consolidated bondholders are chargeable with what was done in the way of paying out earnings in the Clyde suit because such receivership was made permanent on the motion of their trustee.

The record clearly establishes the incorrectness of this statement.

On the hearing whether the temporary receivership should be made permanent many of the mortgage trustees did, in express terms, petition "that the Court "should continue its judicial possession and appoint "permanent receivers."

The only motion or request of the Central Trust Company is:

"The undersigned, as representing the several liens "on the property, designated hereunder, *if the Court "should determine to continue its present judicial possess-"ion of the system*, hereby respectfully petitions it to "appoint Frederic W. Huidekoper and Reuben Foster "as permanent receivers of the Richmond and Dan-"ville Railroad Company" (Record, 167).

We also correct the erroneous statement that the Central Trust Company, as trustee for the foreclosing bondholders was, on its own application, made a party to the insolvency suit on August 16, 1892.

As shown by its proof of claims and schedule attached (Record, 183-185), the Central Trust Company was trustee in a large number of liens besides the consolidated mortgage of October 22, 1886.

Its only petition to be made a party to the Clyde suit was filed July 13, 1892 (Record, 138-141).

At such date there was no default on the consolidated mortgage of 1886.

The petition, after reciting the institution of the Clyde suit and the appointment of Receivers therein, alleged that it was the trustee in the first mortgage of 1874 executed by the railroad company and that there was a default, on July 1, 1892, in the payment of interest due on that lien; that it was also

trustee in what was called the emergency loan of March 29, 1892, whereby the earnings of the system were pledged, and that there was an existing default on that incumbrance.

No mention is made of the consolidated mortgage.

The eighth paragraph of its petition is as follows:

" Your petitioner further alleges that, for the protec-
" tion of the *interests represented by it as aforesaid,*
' it is necessary that your petitioner should be allowed
" to intervene in this suit and have notice and an op-
" portunity to be heard therein *for the protection of all*
" *the holders of the said six per cent. bonds of the*
" *Danville Company and of the subscribers to said emer-*
" *gency loan,*" &c.

The record conclusively establishes:

1. The trustee of the consolidated mortgage was never made a party to the first receivership suit.

2. It did not apply to make such receivership permanent.

3. It never applied for or obtained any order in the cause either as to the disposition of net earnings or otherwise.

4. It never was even notified of any application therein except for the order to postpone its mortgage to $1,000,000 Receiver's certificates.

5. When such order was obtained its mortgage was not in default and it never at any time asserted any claim upon the net income in that suit either for the direct or indirect benefit of the consolidated bondholders.

6. Instead of the first receivership resulting in benefit to the consolidated bondholders, it yielded them no interest and subjected them to a prior lien of $1,000,000 Receiver's certificates, and the burden of $480,000 arrears of interest on the senior mortgages.

There is nothing in the record which in any degree justifies the assumption that the first receivership was either obtained or conducted by or for the benefit of the consolidated bondholders.

7. A ruling of the late Mr. Justice JACKSON was cited in the oral argument to sustain the proposition that the cost of 4,000 tons of heavy steel rails to replace lighter ones was a betterment and not an ordinary operating-expense charge against current income.

The case is Mackintosh vs. F. & P. M. R. R. Co., 34 Fed., 582.

His decision on the point was:

"The practice of the management was to remove "the old iron rails from the main track and use these in "laying sidings, as required, and to put new steel rails in "the main track in place of old iron rails taken up. The "difference between the cost of the new steel rail laid "down on the main line, and as laid down, and the "value of the old iron rail taken up, was charged to "operating expenses, under the head of repairs to "roadway, or 'track repairs.' Thus, in the report for "1881, it is stated that 4,000 tons of steel rails were "laid down on the road. The cost of this, less the "value of the old rails removed, was fixed at $133,- "779.09, which was charged to operating expenses as "'track repairs.' * * *

"The 'repairs,' which Article 4 of the charter pro- "vided should be paid out of net income, did not, as

"between the preferred and unpreferred, or provi-
"sional stockholders, warrant this method of dealing
"with the earnings of the company. It was neither
"just nor fair toward the latter class. Its effect was,
"not to keep the track in repair—in the same state of
"efficiency as it existed on October 1, 1880—but to
"improve and enhance its value at the expense of
"earnings, which are thus reduced, and the provisional
"stockholders correspondingly postponed in coming
"into the company. If necessary to the assertion of
"complainants' rights, this Court would order the
"whole steel-rail account to be charged to construction,
"and earnings credited back with all that has been
"expended therefrom for or on account of steel rails
"and steel improvements."

This Court in Grant vs. H. & N. H. R. R., 93 U. S., 227, defined what repairs were payable as current expenses as those "required to keep the property up to "its usual condition for operation."

"If a railroad company should make a second "track when they had but a single track before, this "would be a betterment or permanent improvement, "and if paid out of the earnings would be fairly "characterized as profits used in construction."

"The works of the company would have an addi-"tional value to what they had before, with an in-"creased capacity for producing future profits."

8. The fourth point of appellee's brief which was most earnestly pressed in argument is that the decree awarding it a special priority of payment should be affirmed because by the operation of a proposed reorganization plan, the Richmond and Danville stockholders were preferred to creditors.

1. No such contention is presented by the record.

The only mention made by appellee of such proposed reorganization is in its application of March 1, 1894, to be made a defendant to the foreclosure case (Record, 365).

It made a printed copy of such "proposed scheme" an exhibit.

The response of the trustee of the consolidated mortgage did not admit any of the averments as to the existence, terms or purposes of such proposed plan.

On the contrary it submitted that all such averments were irrelevant and should be stricken out; that the Court must necessarily adjudge the respective liens and priorities of the foreclosing mortgagee and the rail creditor without reference to any plans which intending purchasers might have, and that in the absence of the reorganization committee the Court was without jurisdiction to render any decree as to the validity of such scheme, or control the distribution of the securities to be issued thereunder (Record, 377).

On the reference to the Masters, the appellee introduced no evidence whatever in support of those allegations in its petition.

Of necessity the Masters made no report on a contention that was practically abandoned or allegations unsupported by any testimony.

In the Circuit Court the appellee filed no exception because the Masters failed to report on its averments as to the reorganization plan.

It was content with the decree rendered by the Circuit Court awarding it a special priority over the mortgage bonds both as a statutory and equitable lien.

In the Circuit Court of Appeals it assigned no cross-error because the Circuit Court had failed to decree

that the reorganization scheme was fraudulent as to unsecured creditors.

It is quite clear, therefore, that if the appellee fails to establish the special priority over the mortgage decreed to it in terms as a supply creditor, irrespective of any plan of purchase, it is not entitled upon this record to claim an affirmance upon the inconsistent theory that by a proposed plan of reorganization, in respect to which no testimony was offered, the purchasers under the decree would acquire the property, or some interest therein, subject to a constructive trust for the benefit of all unsecured creditors.

2. As the reorganization committee were not made parties to the appellee's intervention, the Court was without jurisdiction to render any decree impeaching the validity of the proposed plan of purchase or assuming to direct them in the distribution of the new securities to be issued on the basis of the purchase under the foreclosure decree.

3. The jurisdiction of the Court in a foreclosure suit is restricted to a foreclosure, sale and conveyance of the mortgagor's equity of redemption, the delivery of possession and distribution of the accepted bid.

The equities of general creditors as against shareholders cannot be therein considered or decreed.

The purchaser becomes a *quasi* party only for the purpose of enforcing compliance with his contract with the Court consummated by the acceptance of his bid.

The Court, in a foreclosure suit, is without judicial power to entertain or decide the moot court contention that some intended future purchase under its decree will, if effected, be fraudulent as against the general creditors of the mortgagor.

That issue can only be tried by an original bill filed after the alleged fraudulent purchase has been actually consummated.

The existence of a proposed plan of reorganization cannot enlarge the judicial power or alter the established principles and practice in foreclosure cases.

The scope of the jurisdiction is restricted to enforcing the mortgage and distributing the proceeds of the confirmed bid according to the terms and priorities of the trust deed.

The terms of a possible future purchase cannot be prematurely invoked to control the provisions of the decree of sale.

The priorities and distribution must be adjudged in every respect as though no plan of purchase or reorganization existed.

4. It is claimed that Railroad Company vs. Howard, 7 Wall., 392, is precisely parallel and is decisive upon the point now under consideration.

Upon analysis it will be seen that the controlling facts in the case cited are radically variant from those presented by this record.

In the Howard case, after a completed sale under a foreclosure decree, a judgment creditor of the mortgagor corporation filed a bill to reach that portion of the cash proceeds of sale which was payable under contract directly to stockholders.

Here an unsecured creditor in the foreclosure suit itself, in advance of decree, seeks by intervention to raise an issue as to the validity of a future purchase which possibly may never be consummated.

In the Howard case, the bill sought a ratable application of the fund among all unsecured creditors.

Here, the appellee failing in his efforts to establish his priority as a supply creditor, asks a court of equity to give it full satisfaction out of an alleged fund to which all other unpaid creditors of the Richmond and Danville Railroad are equally entitled to share.

In the Howard case there was no attempt made to displace the priority of the mortgage bondholders, or to apply any portion of the fund going to them under the purchase to the payment of unsecured debts.

The only fund there sought to be reached was that portion of the sale proceeds which was payable directly to stockholders.

Here appellee seeks the affirmance of a decree which gives its claim a priority and right of payment out of the sale proceeds over all foreclosing bonds.

In the Howard case the stockholders paid no assessment, and directly out of the sale proceeds were to receive $552,400 in cash.

Here the stockholders of the mortgagor *solely as such* received neither cash or new securities after reorganization.

The only stockholders sharing in the reorganization were those of the Terminal Company. Their corporation, besides owning the stock of the Richmond and Danville Railroad Company, was a creditor of that company to over $2,000,000, and also owned many millions of bonds secured by mortgage on different portions of the railroad system (Record, 522-524).

The Terminal stockholders were required as a condition of participating in the benefits of the reorganization to pay $7,000,000 (Record, 524).

The share allotted to Terminal stockholders in the reorganization was not given either wholly or to any material degree upon the fact that they were in-

terested in the stock of the mortgagor, but mainly because it was the largest creditor and the owner of many millions of mortgage bonds on lines embraced in the reorganization and because they contributed $7,000,000 new capital.

The Terminal stockholders under the plan did not receive either money or bonds.

They were only allotted certain percentages in the preferred and common stock of the new corporation organized to take title to the system after the reorganization (Record, 52).

In the Howard case the money fund sought to be reached belonged to the mortgagor corporation because the mortgagee and bondholders had in express terms released and discharged their lien upon that portion of the sale proceeds.

This Court thus stated the controlling feature of that litigation.

"Subject to their lien the property of the railroad "was in the mortgagors, and whatever interest re- "mained after the lien of the mortgages was discharged "belonged to the corporation, and as the property of "the corporation when the bonds were discharged it "became a fund in trust for the benefit of their cred- "itors."

Here there can be no possible claim that under the reorganization plan the consolidated mortgage lien was to any extent discharged or any stockholding interest allowed to participate with the foreclosing bondholders on equal terms. The scheme expressly provides:

"Neither the committee, the bondholders, the "creditors or the parties interested in the Terminal "Company, nor those interested in any subordinate "company, by executing this agreement or by becom-

" ing parties hereto, or by reason of any decree of
" foreclosure or other decree that may be rendered or
" any purchase thereunder, waive or surrender any
" legal right or lien in favor of the stockholders or
" creditors, secured or unsecured, of the said Terminal
" Company or of any subordinate company.

" Any purchase or purchases by or on behalf of the
" committee under any decree shall be for the sole and
" exclusive benefit of the mortgage, lien, or other
" creditors for whose benefit such decree may be ren-
" dered to the extent of their legal interest therein, to
" the end that the new company shall acquire under
" such decree or decrees, and the purchasers thereunder
" the titles to the property so purchased, free from all
" claims of stockholders and other creditors, as against
" which such mortgage or lien creditors reserve all
" legal rights " (Record, p. 561.)

The proposed distribution of new securities (Record, 527) shows that the consol bondholders received par in new Company bonds and five per cent. in its preferred stock.

Their original priority for their whole debt was thereby continued under the new organization, for the Terminal stockholders only received preferred and common stock, notwithstanding their contribution to the reorganization of new cash, debts and mortgage bonds.

In this respect the scheme assailed is substantially similar to the reorganization expressly approved by this Court in Sage vs. Central R. R., 99 U. S., 334, when the priority of the foreclosing bondholders' debt was fully preserved in the frame of the new company and "entirely subordinate interests are

"conceded to junior lien creditors and to the "stockholders of the former corporation."

If the appellee has any equity, because of the Richmond Terminal reorganization plan, it can only be asserted by an original bill in behalf of all general creditors of the Richmond and Danville Company, and it cannot on any theory outrank or displace the consolidated mortgage or reach any fund except such subordinate interests in the new company as were distributable to Terminal stockholders.

November, 1898.

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